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## FIRST SESSION

FRIDAY, MAY 16, 1952—9:00 A. M.
*The Ohio Student Union, West Ballroom*

Presiding:

CHARLES L. SMITH, *President, The Ohio Society of Certified Public Accountants; Lybrand, Ross Bros. & Montgomery, Cincinnati.*

Address: "Machinery and Allied Products Institute Accounting Manual"

DUNDAS PEACOCK, *Controller, Elliott Company, Jeanette, Pennsylvania.*

Address: "The Future of Accounting"

MAURICE H. STANS, *Executive Partner, Alexander Grant & Company, Chicago.*

# MACHINERY AND ALLIED PRODUCTS INSTITUTE ACCOUNTING MANUAL

*By* DUNDAS PEACOCK
*Controller, Elliott Company, Jeanette, Pennsylvania*

The Machinery and Allied Products Institute (MAPI) is a federation of trade associations formed in 1933 to bring the diverse industries manufacturing the many kinds of industrial equipment and capital goods into a united and homogeneous organization. Therefore, the Machinery and Allied Products Accounting Manual was prepared for use in the machinery, industrial equipment, capital goods, and allied products producing industries. In these industries, distinctive accounting problems arise from the heavy investment in capital equipment, the relatively long production cycle, manufacture in small lots (not uncommonly, single machines), heavy preparatory expenses for designing and development, and substantial expenditures for erection, installation, and servicing after products have left the factory.

In 1944, the first Accounting Manual, issued by Machinery and Allied Products Institute, was published. This was written substantially during the years 1940 to 1942 but was delayed in its publication for about a year by the paper shortage of World War II. It was substantially a re-write of the accounting manual published by the Machinery Builders Society some years earlier. At the time the 1944 edition of the MAPI Accounting Manual was published, it was considered to be up-to-date in all respects.

During and after World War II, accounting practices and policies changed considerably. New accounting and financial problems were born and others matured to full stature. The sphere of the corporate financial officer was increased by additional responsibilities in such matters as renegotiation, price and wage controls, pension plans, special government contract accounting, the preservation of economic income, and the economic value of invested capital. These changing conditions also increased the need for a comprehension of accounting by non-accounting officers and personnel.

At a meeting of the Accounting Council of MAPI in May, 1948, I remarked that, in many respects, the 1944 Manual had been obsoleted by the changes that had taken place in accounting theories and practices during the war years. A subcommittee of the Accounting Council was appointed to study the 1944 Manual to determine the need for revision and, in September 1948, the committee recommended that a new manual be written. As is generally true in such cases, the one who proposes that a subcommittee be appointed for a particular task is assigned the task of being chairman of that committee. Consequently, I served as the chairman of the Manual Revision Subcommittee. Gentlemen, that was an experience that I shall always cherish. I would not have missed it for a great deal, nor would I want to repeat it. The other members of the Manual Subcommittee who worked on the writing of the new Manual were as follows:

C. E. Headlee, Controller, Westinghouse Electric Corporation, and his alternate, Russell B. Read

Alexander Konkle, Partner, William Kelly & Company

T. D. Lyons, Works Comptroller, Allis-Chalmers Manufacturing Company

E. E. McConnell, Controller, Norton Company

W. A. Neumann, Vice-President, DeLaval Steam Turbine Company, and his alternate, E. W. Clark

James D. Vaughan, Comptroller, American Locomotive Company, and his alternate, Malcolm C. Downs

George D. Ellis, ex officio, Vice-President and Controller, Combustion Engineering-Superheater, Inc.

George L. Todd, ex officio, Vice-President and Controller, The Bullard Company

Professor Gould Harris of New York University and Maurice E. Peloubet of Pogson, Peloubet and Company, Public Accountants, acted as consultants to the Committee.

The Committee started to work in January, 1949. About a year was spent in preliminary discussions, and the following points were agreed upon:

(a) The new Manual was to be, in all respects, a new Manual and not a re-write of the old manual.

(b) In addition to being an accounting Manual, it was also to be a means of conveying to non-financial corporation management, educators, governmental policy makers, union leaders and others, the potentialities of accounting as a useful tool of management rather than a morgue for historical figures.

(c) The Manual was to modern. It was to avoid accounting terminology that had meaning only to persons trained in accounting and versed in its peculiar terminology.

(d) The Manual would, so far as practical, avoid repetition of material available elsewhere in printed form.

Originally, it was expected that the drafting of the Manual would be done by Professor Gould Harris of New York University and Maurice E. Peloubet of Pogson, Peloubet and Company. However, the unfortunate illness of Professor Harris necessitated that the Committee members undertake to draft the Manual themselves, with Professor Harris and Mr. Peloubet acting as consultants.

It took more than twenty-five meetings of the Manual Subcommittee to complete the writing of the Manual, to say nothing of numerous meetings held by individual members of the Committee, and a great deal of time spent by each member outside of committee meetings. Most of the meetings lasted two or three days and they were days of concentrated effort. Sometimes Sections were rejected by the Committee several times with suggestions for changes, before a draft suitable for final committee editing could be completed. As many as five different Committee members undertook the writing and re-writing of a Section before the Committee was satisfied. No member dared have any pride of authorship, and after a Committee member had the experience of having the Section that he had written ruthlessly torn apart by the Committee, he was not loathe thereafter to help give similar treatment to other Sections that had been written by other members of the Committee. Consequently, this is one book that can truthfully be said was written by a committee and not by a ghost writer. We expected that it would be necessary to refer the manuscript of the completed manual to a professional editor to eliminate differences in style, since different persons had been responsible for the drafting of the various Sections. However, when we referred the completed draft to others for criticism and suggestions as to editing, we were pleasantly surprised to be informed that editing was not necessary. In other words, in the final Committee editing, individualistic style had been eliminated from the manuscript and the finished article was a Committee composite. Consequently, no further editing was done before the draft was given to the publishers. The Manual was published in January of this year, and its general acceptance by the member companies of the MAPI and others has been gratifying.

The Manual is divided into ten Sections as follows:

| | |
|---|---|
| Section I. | Classification and Description of Accounts |
| Section II. | Financial Statements and Reports |
| Section III. | Property, Plant, and Equipment |
| Section IV. | Manufacturing Cost |
| Section V. | Sales Engineering and Administrative Expenses |

Section VI. Pensions
Section VII. Internal Control and Auditing
Section VIII. Cost Estimating and Its Uses
Section XI. Profit Planning and Budgeting
Section X. Recognition of Changing Value of Dollar

Obviously, it is not possible to discuss comprehensively within the covers of such a Manual all of the above subjects. Therefore, where suitable material is available elsewhere, a discussion is limited. A comprehensive list of sources from which more detailed information may be obtained is included as an Appendix to the Manual, and comprises eight pages of references.

SECTION I. CLASSIFICATION AND DESCRIPTION OF ACCOUNTS

Section I contains listings and descriptions of the accounts that generally will be required by the average manufacturer of industrial machinery and equipment for proper control of the business and for determination of financial position and results of operations.

You will note the use of the word "description" rather than the more commonly used word "definition." It soon became apparent that it was necessary to describe the uses of accounts rather than to define the contents of accounts. Sometimes the description pertains to a single account and sometimes to a group of related accounts.

The account descriptions represent the composite opinion of the Manual Committee as to the best accounting practices necessary to portray operating facts in the machinery industry. Occasionally, alternative practices are indicated, with reasons given for the practice recommended by the Committee.

The nature of a coding system for accounts is explained and illustrated in the Manual. How best to arrange accounts for budgetary control purposes is also illustrated, i.e., arrange accounts functionally and by departmental responsibility. It was the opinion of the Committee that successful budgetary control depended, to a large extent, upon proper arrangement of the accounts according to divisions of the company, functions, and supervisory responsibility.

I could spend all of the time allotted to me, and more, discussing the details of the various account classifications and the descriptions of account use and practices contained in Section I of the Manual. Ofttimes, many hours in committee meetings were devoted to very interesting discussion of accounting practices which resulted in an account description comprising one or two small paragraphs. Obviously I cannot do that, because there are things I want to tell you about the other Sections of the Manual. However, let me touch on just a few of the accounts that I believe may be of interest to you.

The manual states as follows:

*Patterns, Tools, Jigs and Fixtures, etc.*

"Most machinery and allied products manufacturers have available for use large quantities of patterns, tools, jigs, fixtures, etc., the cost of which represents a considerable sum. Some of these items may have an appreciable term of useful life, while others may not be used a second time. To capitalize such items and to amortize the cost, either on the basis of the estimated units to be produced therefrom, or on the basis of the estimated period of useful life, is impracticable. Consequently, it is an established practice to charge the cost of such items to expense when acquired, or, if they were prepared or acquired for specific customer's orders, to charge the cost to the cost of the orders for which acquired. Instead of charging the cost of such items to expense when incurred, another common practice is to group the cost of such items and to amortize the cost over a short period of time such as two or three years.

"Machinery and allied products manufacturers also have a substantial investment in smaller and less valuable semi-durable tools and instruments of a portable nature, which may have a comparatively long term of effective life but which, because of their size, movability, and relatively small unit cost, cannot practicably be controlled even though capitalized. An established practice in industry is to charge the cost of such items to expense when purchased; or, if they were acquired for use on specific customer's orders, to charge the cost to the cost of the orders for which acquired.

"Some companies desire to reflect the worth of such items in the Statement of Financial Position and hence record in the accounts the estimated valuation of a normal or working complement of such tiems. Acquisitions are then charged to expense when acquired. If the normal complement is increased as a result of expansion, or the addition of a new standard line of products, the recorded worth is increased and corresponding credits made to the appropriate expense accounts. This practice is not general but when used is extended to the following accounts: Patterns, Molds, Jigs, Punches, Dies, and Machining Fixtures; Metal Flasks; and Semi-durable Tools and Instruments."

*Manufacturing Cost of Sales*

Manufacturing Cost of Sales includes: Factory Cost of Sales, Costs of Development, Purchased Auxiliaries, Preparation for Shipment, Field Assembly and Installation, Other Direct Costs Applicable to Sales Billed, and Current Variances from Standards. It is advocated that Manufacturing Costs should be classified by lines, types or sizes of products, by plants or divisions, etc., to the same extent that Sales Revenues are segregated, so that earnings may be determined for each sales category.

One difficulty that all members of the Committee had experienced when dealing with non-accounting trained management personnel was in explaining why the factory expenses allocated to Factory Cost of Sales were not reconcilable with the factory expenses of the current month, and that the factory expenses in Factory Cost of Sales had been previously accumulated in Inventory Cost at standard rates and transferred therefrom as part of Cost of Sales. Consequently, in an attempt to minimize confusion, the Chart of Redistributable Factory Expense Accounts was segregated from Manufacturing Cost of Sales in the Manual and was included at the end of Section I under the heading, "Redistributable Factory Expenses." This Section explains how factory expenses are divided according to functions and departments and how the expenses are allocated to Cost of Production by application of standard rates applied to direct labor cost, direct labor hours, machine hours, or whatever logical base has been selected for that purpose.

*Sales Engineering*

Sales Engineering Expenses are divided into:

*Field Sales Engineering*, i.e., all expenses incident to the activities of personnel attached to district sales offices.

*Headquarters Sales Engineering*, i.e., factory or home office sales engineers who are product or industry specialists and supplement the work of field engineers and are responsible in assisting in determination of the size, type, and design of equipment necessary to comply with the needs of the customer.

*Executive Sales Engineering*, i.e., salaries and expenses of executive sales engineering personnel responsible for direction and coordination of field sales engineering and factory or headquarters sales engineering.

Typical charts of expense accounts for each of those categories are contained in the Manual. A separate Section—Section V—is devoted to discussion of control and accounting for these expenses. I shall comment further on that section later.

*Redistributable Engineering Expenses*

Included in this classification are:

*Design Engineering*, i.e., responsibility for modifying existing product designs to meet customers' specifications, improvements in design of existing products, and engineering assistance in negotiating sales contracts.

*Drafting*, i.e., salaries and expenses of the Drafting and Blueprint Departments.

*Research*, i.e., salaries and expenses of research engineering personnel responsible for research and experimentation in new product lines and fundamental improvements of products and processes.

Since most of the work of design engineering relates to specific customer contracts or to authorized projects for product improvement, the Manual states that it is advisable to treat the Design Engineering Department as a productive department and that the compensation of design engineers, plus allocated engineering department expense, should be charged to jobs and projects accordingly. If the organization of the Engineering Department makes it feasible to do so, this account classification should be subdivided by product groupings.

Drafting salaries and expenses should be distributed to jobs and projects in the same manner as design engineering.

The Manual recommends that research expenses should be transferred monthly to the research expense account where total cost of research is accumulated, and should be controlled by authorized project budgets.

Typical charts of expenses for each of these redistributable engineering departments are contained in the Manual.

### Section II. Financial Statements and Reports

Section II is divided into two subjects, namely, reports to shareholders, and reports to management. Illustrations of the recommended Statement to Financial Position and of Statement of Results of Operations and of Income Retained for Use in the Business, together with Supplementary Financial Information, are shown in the Manual. You will note that we have abandoned the terms "balance sheet," "profit and loss statement," and "statement of surplus."

The form of Statement of Financial Position recommended for the report to shareholders is the form that is in increasing use nowadays where current liabilities are subtracted from current assets to show working capital; then other assets are added and other liabilities subtracted and the balance represents the shareholders' equity. In the Statement of Results of operations, it is recommended that Federal taxes on income be included with costs and expenses and that no balance be shown before deduction of Federal taxes on income.

Two very pertinent statements are made in the introductory remarks for this Section, which I quote:

It must be realized that conventional accounting is based on historical dollar costs. Therefore, amounts shown on the Statement of Financial Position are not necessarily equivalent to liquidation values, economic values, nor replacement values in current dollars. Likewise, amounts charged to current operations and reflected in the Statement of Results of Operations, do not necessarily represent the economic values actually used or consumed in operations of the current period. Since changes in the purchasing power of the dollar are continually in process and sometimes, as in recent years, are sudden and sharp and of substantial magnitude, it is recommended that where the possibility exists of ommission of material fact, explanations be made in financial statements by footnotes or by supplementary reports.

In the part dealing with Reports to Management, it was possible to show only a few illustrations of the types of reports on results of operations we felt should be furnished to corporate management. To have attempted to illustrate all conceivable types of reports would have been an obvious impossibility. It is emphasized that statements and reports for management should be prepared to convey clearly and concisely the essential facts needed by management for the proper conduct of the company's affairs. Some company managers wish numerous statements and voluminous reports, with narrative comments on important facts and trends indicated thereon, while others prefer concise factual reports containing a few pertinent figures.

### Section III. Property, Plant and Equipment

Section III contains a discussion of the methods used to account for and control investment in property, plant, and equipment. There is also a short, concise, and yet complete discussion of the accounting practices for reflecting, through charges for wear and obsolescence, the cost of a capital facility charged to current cost over the economically useful life of the facility. The topics of replacement, repair and maintenance, and disposition are also discussed herein.

### Section IV. Manufacturing Cost

Section IV deals with the determination of manufacturing cost, which obviously is one of the most important aspects of accounting, since results of operations will be incorrectly stated unless manufacturing costs are accurately computed. Also, accurate determination of manufacturing cost is an important aid in establishing sales prices, in redesign of products, in cost reduction, and in determining the abvisability of continuing, discontinuing, or expanding product lines.

The flow of manufacturing costs is illustrated by two diagrams, one of which illustrates flow of costs into inventory accounts and to manufacturing cost of sales when job cost accounting is employed, and the other illustrates the flow of costs when standard cost accounting is employed.

Under the caption, "costing methods," there is discussion of job order costs, standard costs, and process costs. The basic elements making up factory costs are explained and the several methods used to apply to factory expenses in the determination of factory cost of jobs and products are described. The fundamentals of determining normal burden rates and the accounting for variances between actual expenses and expenses allocated by the use of standards, are also discussed. Recognizing that a great deal of textual material exists with respect to cost determination, this Section was condensed to the point where every sentence is pertinent. Although greatly condensed, the Section is quite complete. I wish that time permitted me to tell you more about the discussion of costing methods and costing practices.

The second part of the Manufacturing Cost Section deals with inventory pricing methods. It is pointed out that "the selection of an inventory pricing method is a dual problem, for it involves not only the question of valuation of inventories, but also the question of the basis for determination of manufacturing cost of sales and of net income. Were the cost of materials, labor and services always constant, there would be no problem, for cost would be the only logical basis to use for both purposes. However, costs of materials, labor and services are seldom constant, and often increase or decrease appreciably during an accounting period, or between accounting periods. This raises several questions of policy that must be decided when selecting the inventory pricing method or methods to use, such as:

(a) Should the inventory valuation be based on acquisition cost of materials in stock and the manufacturing cost of sales be charged with the acquisition cost of materials sold?

(b) Should the inventory valuation be based on the original or base cost and the manufacturing cost of sales be charged with the latest cost of the materials sold?

(c) Should average cost be the basis used for pricing inventory and charging manufacturing cost of sales?

Five different methods of inventory pricing are explained, namely, first-in, first-out (FIFO) last-in, first-out (LIFO); standard cost; normal or base stock method; and retail method.

It is pointed out in the Manual that, "No single method of inventory pricing is ideally suited to all companies, nor is one method necessarily suitable for all inventory classifications within a single company. For instance, one company might find it advisable to value its principal raw materials by the 'last-in, first-out' method, other materials by the 'first-in, first out' method, application of factory expenses by the standard cost method, and factory supplies by the average cost method."

The "first-in, first-out" method is the one most generally used in the industry and that is relatively simple to explain. The "last-in, first-out" method has not been widely applied in the machinery industry, but it is being used much more since the "dollar-value method" was evolved relatively recently. The Committee found itself in somewhat of a quandary for it felt that it should explain the workings of the dollar-value LIFO method of inventory determination in some detail. However, to do so required so much space that it appeared as if we were recommending the use of that method in preference to FIFO or standard costing. Consequently, the Section of LIFO was condensed as much as possible, while still being understandable and reference was made to the article by Leon M. Nad in the February 1951 issue of the *Journal of Accountancy* entitled, "How to Simplyfy LIFO by Use of Dollar-Value Method."

Accounting for field costs, i.e., cost of installation, and guarantee and repair are also discussed in Section IV.

### Section V. Sales Engineering and Administrative Expense

The introduction to Section V states the following:

> Careful application of Sales Engineering Expense and of Administrative Expense by product lines is of increasing importance in the machinery industries. While the necessity for determining *Manufacturing* cost by product lines has been recognized for many years, only limited attention has been given thus far toward similarly applying the other two major elements which comprise total cost.
>
> Sales Engineering Expense and Administrative Expense vary widely in ratio to sales prices within companies manufacturing a variety of products which differ substantially as to price, markets or competitive conditions. These differences, and the additional fact that Sales Engineering Expense and Administrative Expenses are an important proportion of total cost, require that more exacting attention be given to such methods of determining distribution to product line cost. . . .

The discussion with respect to Sales Engineering Expenses contained in Section I is amplified in Section V. In addition, there is discussion of a technique that is used in the machinery-manufacturing industries for determining the distribution of field sales engineering expense to product lines. It is often erroneously assumed, as to Field Sales Engineers engaged in the sale of all or several of a company's products, that the Field Sales Engineering expenses apply equally to all products of the company in relationship to the sales prices. Studies of many such operations demonstrate this assumption to be erroneous when a company manufactures products that vary widely in price, market or competitive conditions. In fact, the relationship of Field Sales Engineering expense to the product sales dollar may vary enormously as between different products. Unless this variation is known when analyzing costs and profits by product lines, a company may believe to be profitable, products on which losses are actually sustained.

## VI. Pensions

In Section VI are stated the general characteristics of the more common types of pension plans, and the methods of accounting for liability and cost. There is one paragraph in this Section that I should like to quote to you:

The use of the words, 'past service credits,' in connection with pensions, is unfortunate, for they erroneously imply that a payment is being made for service rendered in the past. It would be more accurate to describe 'past service credits' as, 'credits for future service calculated on past service.' Length of service is merely a measuring device, and the inclusion of service prior to adoption of the plan in the calculation in a means of providing a large pension to long-service employees than to newcomers. However calculated, pensions are never paid for 'past service' rendered when there was no obligation to pay, nor any right to expect a pension. It is true that a larger pension may be paid, proportionately to earnings, to an employee who was in the service of the company many years at the date of adoption of the plan than to a newcomers, but the pension is paid for future service in either case. Nevertheless, the words 'past service credits' are generally used in pension plans; consequently, in the interest of brevity and to avoid confusion, the use thereof has been continued herein.

## Section VII. Internal Control and Auditing

The objectives of internal control and auditing are discussed in Section VII, and a suggested internal audit program is included. A member of the Machinery and Allied Products Institute Accounting Council told me that he had not been satisfied with the internal audit program that his internal audit staff had been following, and that he had requested them to compare their program with the program contained in the Manual with the result that the suggested program contained in the Manual was adopted in total, in lieu of the program that they had been using.

The objectives of the internal audit program are summarized as follows:

1. To determine that authorized policies and procedures are being followed, and to make sure that they provide, at reasonable cost, adequate protection against loss and inefficiency.
2. To review the system in use to determine the adequacy of the various methods and procedures.

3. To determine that the normal checks and balances of the established internal control procedures are working, and that they provide reasonable protection to the company against loss.
4. To report on the competency of personnel responsible for various phases of the work covered by the internal audit program.
5. To observe opportunities for increasing profits.

### Section VIII. Cost Estimating and Its Uses

The use of accounting information for cost estimating, with the objective of determining cost to the greatest degree possible before the actual expenditures are incurred, is discussed in Section VIII. The various uses of cost estimates are recited and the prerequisites for reliable cost estimating are given. The adjustment of costs to reflect probably future experiences is advocated.

### Section IX. Profit Planning and Budgeting

Section IX is divided into five parts, namely (1) Forecasting, (2) Budgeting, (3) Analysis and Control of Variances, (4) Break-even Point Determination, and (5) Profit-to-Volume Relationship.

This was one of the most difficult sections to write because of the tremendous scope of budgetary control. The Committee had difficulty determining how best to approach the subject, and to what extent it should be discussed. Before the Section was finally approved, five different members of the Committee had attempted to draft the Section.

The Committee recognized that adequate budgeting is still in its infancy in the majority of companies. Those companies that have explored complete budgetary control have found it to be an extremely valuable tool of management and a practical basis for coordinating the effort and planning of the managers of a business toward a common objective. Unfortunately, many companies look upon budgetary control only as a means of attempting to control expenses, and have not yet discovered the greater advantages to be derived from budgetary control of all phases of a company's business.

Recognizing that a great deal of resistance to budgetary control stems from incomplete understanding of the objectives, we decided to limit ourselves to attempting to convey a comprehensive picture of the scope of budgeting and to illustrate rather simply how budgetary control can be effected. We point out that budgeting starts with a forecast of operations, of orders and billings, of costs and expenses, and of profits. We point out that the budget is a tool of management designed to help plan and control all phases of the operation of the business. It establishes predetermined objectives, provides a comparison of actual attainment against those objectives, and focuses management's attention on those items where actual attainment is markedly at variance with the objectives.

We point out that the compilation of the budget should follow organizational lines by functional responsibilities, should represent the coordinated effort of all concerned, and must be sound and realistic without being arbitrary.

It is explained that the budgeted results of operations is the keystone to a complete budgetary control system, and that the expense budgets should be correlated therewith.

It is also explained that expense budgets may be divided into three general classifications, namely:

1. Period or fixed amount expense budgets which vary with time.
2. Flexible expense budgets which fluctuate with the changing level of activity.
3. Project budgets, i.e., amounts approved for specific projects.

The establishment of budgets for each of those categories is discussed and illustrated.

Typical budget report forms are contained in Section IX, and illustrations of graphic means for portraying budgeted vs. actual results are also shown.

## Section X. Recognition of the Changing Value of the Dollar

As you may surmise, Section X, dealing with the changing value of the dollar, was the most controversial Section of the Manual. The Committee was divided at first between those who believed that it was possible to reflect changing economic values in the accounts of a company, and those who believed that to do so was both impracticable and inadvisable.

The economic problems resulting from changes in the purchasing power of the dollar, both current and long term, are discussed in this Section. The extent of over-statement of profits during and following World War II is also discussed. Summaries of conflicting views of leaders of accounting economic and business thought with respect to recognition of the changing value of the dollar are also included.

Last, but not least, there is a specific recommendation to users of the Manual, which is as follows:

> It is not the purpose of this Manual, nor of this discussion of the need for recognition of the changing value of the dollar, to recommend departure in the accounts from conventional accounting for historical dollar costs, for this Manual presents throughout the concept of conventional accounting on the basis of original dollar costs.
>
> The problem, nevertheless, is acute and demands recognition and solution by

accountants and management. It is accordingly recommended that the individual company managements and their financial advisers undertake renewed investigation of their financial accounts in terms of economic income and economic values. It is recommended that they use the knowledge thereby gained in devising improved accounting methods for general use, in analyzing their cost data, in the development of interpretative internal reports, in the initiation of suitable accounting memoranda, and also in explaining these relationships in supplemental reports to stockholders and the public.

I stated earlier that one of the objectives of the Committee in writing the Manual was to provide a means of conveying to non-financial corporation management, educators, governmental policy makers, union leaders, and others, a better understanding of accounting and of the potentialities of accounting as a useful tool of management. Since the Manual was published in January, the reaction from corporation executives of member companies has indicated that we have achieved those objectives—at elast in part. Several commendatory letters have been received at MAPI headquarters from corporation presidents and operating executives, stating that they had received from the Manual a much better understanding of accounting, and of its uses, than they had had theretofore. One high echelon official of the General Accounting Office refused to believe that the Manual had actually been written by a committee of corporate accounting officials and wanted to know who had been the ghost writer. When ultimately he became convinced that the Manual had been written in the manner that we stated, he was most commendatory in his remarks and promised to bring the Manual to the attention of other members of the staff of the General Accounting Office.

The Machinery and Allied Products Institute is desirous of having the Manual used widely in colleges for teaching and reference purposes, and is prepared to give to colleges a discount to encourage the purchase of the Manual for that purpose.

Recognizing the desirability of the Manual being made available to governmental personnel concerned with accounting, some companies that are members of MAPI have been buying copies to present to cost inspectors, tax examiners, etc. MAPI has also suggested that member companies buy copies for presentation to universities and libraries.

If the Manual subsequently proves to have been a help in increasing the appreciation of accounting as a useful tool of management, if it brings about greater uniformity of accounting in the machinery-manufacturing industry, and if it helps to bring governmental concepts of accounting closer to the ordinary and necessary practices of American industry, the Committee will feel well repaid for its efforts.

# THE FUTURE OF ACCOUNTING

*By* Maurice H. Stans
*Executive Partner, Alexander Grant and Company, Chicago*

## Introduction

A project of the future of any of the arts or sciences involves a combination of prophesy, romance, and unlimited imagination. The distinction between fantasy and practical expectation is hard to find when looking past an indefinite present horizon into an unbounded and unlighted expanse.

Yet it is possible to select a probable course into the future from the directions of the past. The steps of progress always have a certain consistency and it is not to be expected that sudden turns will divert movements of the past into wholly new paths. The future, to some extent at least, is a projection of the events that have already taken place.

Because of its rapid recent evolution, accounting is largely a Twentieth Century art, though its roots have been planted for centuries. The rapid pace of its developments has taken on special acceleration in the last twenty years and it is clearly in a state of flux even now. Books are being written about its "changing concepts," studies are being undertaken to search and research the soundness of its premises, and its general principles have yet to be enunciated authoritatively. For these reasons, it might seem difficult to evaluate the forces which give it momentum, but actually there is a great deal of clarity in its general direction. The course seems to have been outlined in the utilitarian objective so well expressed in 1939 in Accounting Research Bulletin No. 1 of the Committee on Accounting Procedure of the American Institute of Accountants:

> The committee regards corporation accounting as one phase of the working of the corporate organization of business, which in turn it views as a machinery created by the people in the belief that, broadly speaking, it will serve a useful social purpose. The test of the corporate system and of the special phase of it representd by corporate accounting ultimately lies in the results which are produced. These results must be judged from the standpoint of society as a whole—not from that of any one group of intersted parties.
>
> The uses to which the corporate system is put and the controls to which it is subject change from time to time, and all parts of the machinery must be adapted to meet such changes as they occur.

In planning the future of accounting in the light of this objective and as an extension of the recent past, it seems practical to adopt these four divisions of the subject:

1. Accounting as a technique.

2. Accounting as a social force.
3. Accounting as a profession.
4. The place of the accountant.

Before approaching these analyses, however, it is necessary to give some consideration to the general setting, and the conditions under which any developments are likely to occur.

## The Setting

From the time of first recorded history, man has been engaged in a two-fold struggle with his physical environment and with mankind. In general, he has been winning the former and losing the latter. He has gained comfort, convenience and a reasonable degree of physical safety, but he has failed to achieve a peaceful world. He has conquered the elements and created scientific miracles, but has not learned how to live with his fellow man.

It is a curious phenomenon. In the Christian era, there have been 1952 years of uncertainty, 1952 years of predicted doom, and 1952 years of physical progress. There have been periods of temporary peace, but no times of confident security.

The present is no exception. The implements of destruction created by science have become so powerful that they threaten to wipe out whole cities in a single stroke. International tensions have built into an alignment that finds most of the nations on one side or the other of a threatened fight to the finish. Meanwhile, rival political systems fight for control of long-established institutions and urge internal class struggles among the people while their countries are at uneasy peace. To an observer from another world, our planet would undoubtedly give an impression of intense dissatisfaction, jealousy, and rivalry amidst growing plenty.

Despite all this, it is sensible to take hope from the physical and social gains of the past, especially those in the last half century. The great improvement in the standard of living in the United States in this period is significant, even though it affected a small part of the world's population, because it points a way for others. The social adjustments of the same years demonstrate that the democratic process, slow though it is, can be made to cope with the uncertainties of human existence and to assure a greater security.

A backward look at these last fifty years reveals three highly important trends to be dealt with in an evaluation of the future of accounting:

(a) The development of the mass production systems in industry, with their great emphasis on cost accounting and efficiency.

(b) The trend toward greater government influence in the affairs of business, through taxation and regulation.

(c) The great expansion of industrial activity, based largely upon the products of scientific research, until widespread ownership and with greater demands on accounting for financial control.

The new industries of the Twentieth Century are numberless. The past fifty years have brought the automobile and with it the developments of rubber and oil. The automobile was followed in the field of transportation by the airplane and the science of aerodynamics came into being. Synthetic chemistry developed thousands of new products in the fields of plastics, clothing and many articles of daily utility. Medicine brought its miracles from mold, earth, and even less attractive substances. In agriculture, science moved from soil analysis to chemical additives to hydroponics. Scientific breeding brought hybrid corn and sturdier cattle and wingless chickens. Refrigeration came to protect man's food and increase his comfort. Wireless communication developed into radio and then television and in the meantime the whole broad field of electronics was created. Physicists unveiled radium, went through the scale of atomic weights and pushed beyond into nuclear physics until they finally untied the power of the atom. Men began to wonder again, as they had wondered many times before, whether science had gone too far.

As each new product was unveiled, free enterprise capital united with free enterprise management under the profit system to bring it to the masses of people at the lowest possible cost. Engineering and cost accounting became partners in cost reduction programs aiming at the ultimate in efficiency and economy. The over-all planning and control of operations became part of the accounting science as budgeting and the controllership function grew up together and became a vital part of management.

The impact of taxes and government controls upon accounting needs no elaboration. From the time that the Sixteenth Constitutional Amendment was adopted, the accounting term "income" became a new subject of taxation. Every subsequent economic control over business or government exaction from business meant new demands upon accounting—security regulation, price control, wage and salary control, materials allocations, the social security system, and so on. The test of the importance of accounting in all of these is made clear by asking how they could have been made possible without accounting.[1]

[1] Those who are close to a fact for some time are least able to see it. Sometimes, too, it is difficult to distinguish between cause and effect. Recently a British team of investigators undertook to study American business accounting practices as part of a study of American industry. What they learned about cost accounting, internal auditing and the function of controllership was a revelation, because these things do not exist in Britain. It may be exaggera-

Students of the social movements of the last five decades recognize this in terms that leave no doubt. The reformed Communist, Whittaker Chambers, expressed it most aptly when he characterized the social changes of the "New Deal" as a "reform movement—a revolution. It was not a revolution by violence, but by bookkeeping and lawmaking."

Each of these three fundamental forces—the expansion of industry, the fight for productivity, and government participation—promises to be with us in the next fifty years. Scientists like Dr. Vannevar Bush predict:

1. New ways of cultivation of food in the seas—fertilization in feeding to increase the yield of fish; scientific control of the diet of oysters; harvesting of protein from tiny shellfish; promoting of feeding ponds for fish.
2. New methods of reclaiming land—laying down fertile silt in swamps, later to be drained; exterminating wild predatory grasses to permit cultivation of cereals; using new synthetic chemicals to bond clay soils and avoid soil bacteria.
3. Scientific ways of increasing meat production—use of vitamins and antibiotics to increase growth of chickens and hogs; using vegetable proteins instead of animal proteins; feeding pigs by milk formula to cut mortality; isolating a strain of sheep that produces twins.
4. In medicine, enhancing the health of the population by maintaining normal hormonic balances.
5. In chemistry, creating pure water from salt water and selecting chemicals from the seas.
6. In industry, the employment of automatic machinery to a greater extent than ever.

Dr. Roger Adams, president of the American Association for the Advancement of Science, is quoted as follows:

"In the future, citizens will more effectively farm the land and the seas, clothe themselves from coal and oil, and keep themselves warm by using a storage of the sun's energy.

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tion to claim that the absence of these ingredients is the reason for the decline of the British production standards but it can well be argued that their presence might well have suggested the increases in productivity that could have been realized there by more attention to the introduction of new equipment, labor saving methods, and so on. It may well be a tribute to American accounting that the physical output per worker per year averages 2.8 times greater in the United States than in Britain. Would any system of cost accounting or controllership have failed to recognize that in the textile industry a high proportion of machinery in Britain is over forty years of age, that only 6 per cent of the looms are automatic, that the majority of sewing machines are from thirty to forty years old, that the average capacity of coal mining machines is only one-eighth that in America, and so on?

Another circumstance that may demonstrate the superiority of American accounting practices is in the effectiveness of its tax collecting system as compared with that in countries like France and Italy where a partially developed system of accounting had been so inadequate as to permit the failure of the entire effort at income determination. Accounting in France is so bad that a new government recently granted an amnesty to all tax evaders in the hope that if their sins of the past were forgiven they might keep better books in the future.

"They also will be cured of any ailments by a variety of drugs and medicals, be happy, healthy and kittenish at 100 years of age, and perhaps attend interplanetary football matches in the Rose Bowl."

The science fiction stories of space ships and of Sunday afternoon picnics on the moon are no longer exciting in a day when government speaks of building satellites to circle the earth at a fixed altitude. Who would venture to name the limits of scientific surprises to follow the harnessing of the atom to produce electric power or the creation of electronic computers that do a year's equations in a minute? Can we doubt the scientists today who predict that within a decade or two man will learn how to counteract the force of gravity, so that airplanes with engine trouble will stand still in mid-air while they are being repaired?

This is the setting in which the future of accounting must be visualized. It is an astounding outlook, because the gains of the past fifty years will probably belong to the horse-and-buggy age by the time the next fifty years roll around. It is significant that a British scientist recently said, in analyzing the problem of communicating with people on distant planets, that the first means of establishing contact will be by numbers.

Some things are at once clear. The refinements of accounting techniques will be no less essential because of the invention of any "mechanical brain." The problems of recording, of the application of judgment and principles, and of reporting will still remain (as will be seen later) in days of planetary transportation or interstellar communication. A faster pace of life in an age of nuclear dynamics will increase rather than decrease the public interest in the economic facts of life.

But before it is possible to venture ahead in imagination, a next factor to be considered is the political and social climate. Where do the reform movements, the trends toward socialization, lead to?

In many respects, the major uncertainty about the course of accounting development springs from the threats of change in the political system. So long as a democratic form of government prevails, and retains with it a climate that encourages free enterprise and the profit motive, accounting will retain its full potential. On the other hand, a nationalization of a large segment of industry or finance could lead to the paralysis of accounting. Where the nationalization occurs, the government bureaucracies control accounting, and where that exists, accounting must not only become mechanical and regimented, but interpretative accounting passes to the hand of the politicians rather than the independent analysts.

An even greater political change to some form of Fascism or Communism in government would, under all present evaluations of such systems, further reduce accounting to a matter of classification and summarization according to rule books and regulations. Whether or not such generalizations as to the course of accounting under political systems are wholly justified, it is a fair conclusion that the free system offers accounting its greatest opportunity, while at the same time posing its greatest challenge. This is true because it is only under an economy in such an atmosphere that a real social partnership between labor, capital, management, and government seems possible and, in such a partnership, accounting is the only practical measurement of the economic aspects of human relationships. Accounting is the language of business, which means that it is the only practical vehicle of economics in an industrial system. In the challenge of bringing about the peaceful distribution of the economic product of the free system accounting can find its most difficult task and its most promising future.

With this setting of scientific advancement, industrial productivity and social unrest, it is now possible to consider some of the details of accounting's future. If justice is to be done to the search, a degree of imagination commensurate with the scale of the setting must be applied.

## Accounting as a Technique

The first of the facets of the subject of accounting change is that of developments in techniques. Any projection of the developments in accounting procedure of the last fifty years into the next half century establishes fairly well the fact that substantial modifications of accounting practice are bound to continue to occur.

One of the interesting probabilities at this point is that accounting will remain an art while at the same time becoming an expanding science. The fact that its function is utilitarian and that its presentation in measured amounts give impressions of certitude tends to classify accounting in most lay minds as a scientific thing. Accountants themselves resist such implications because of the extent to which varying judgments must be applied. Nevertheless, it must be concluded that standardization and uniformity will be more nearly approached in many respects in which individuality now prevails.

Accountants have not yet laid down a body of general principles. In its absence, general acceptance is now the criteria. However, general acceptance is a flexible standard, because the acceptance is by the creator of the practices rather than by those to whom its findings are addressed. If accounting were to codify its general principles, then many of the present wide areas of judgment would be restricted and scientific reasearch into practical application of the principles would be facilitated.

Thus, within the general area of techniques, it is apparent that accounting at the present stage needs and will soon find these things:

1. A comprehensive code of accounting principles promulgated by professional accountants and kept current by intensive research.
2. A realistic definition of "truth" in accounting aimed at producing representations that are reliable for the purposes intended, rather than precise.
3. Supplementing the body of principles, the achievement of standardized terminology, methods of presentation and requirements for disclosure, all aimed at assuring accounting truth, as here defined.

Not until all of these are seriously attempted will it be possible to know the extent to which accounting can progress in the first phase of fulfilling its future opportunities. The achievement of these steps, accompanied by reasonable provisions for enforcement through professional ethics, would create all that is to be desired in the way of reliability, uniformity, and comparability in accounting representations. Only through the achievement of these characteristics can accounting gain the confidence among lay people that will justify it in aiming at greater horizons. The social need for a better understanding of business will dictate these refinements in accounting techniques.

Within this broad framework, it is to be expected that underlying techniques will continue to be refined. Cost accounting needs its own subordinate body of principles; once these are authoritatively expressed, the refinements in application will be unlimited. The same detail which has enforced the continual search for economies of a fraction of a cent will become general and more uniform throughout industry. As a corollary, distribution costs will be given the same searching consideration that manufacturing costs will get. Business planning and budgeting will become standard for every business regardless of size. Internal auditing will expand so that it becomes not only a control over procedures, but a method of enforcing policy. The findings and dictates of controllership will override the objections of so-called "operating" departments.

It is to be expected that more will be accomplished in the way of comparability and uniformity within specific industries. Uniform classifications of accounts will lead to uniform rates of depreciation and uniform methods of presentation in financial statements. Readers will gain an increased understanding at no sacrifice to anyone.

Without question, the process of recording transactions will benefit by vastly greater mechanization and simplification. Time and motion study in paper work and the introduction of labor-saving devices will be as important in the office as in the plant.

Undoubtedly income concepts will become more stabilized than they have been. The reluctant trend toward the all-inclusive concept of income will most likely continue with the result that ultimately all recognized financial events of the period will appear in the income statement and the aggregate result will be designated as "net income." All arguments for the showing of undistorted operating results will be met by classification within the statement, making full disclosure readily possible in all circumstances.

Many years will elapse before the problem of dealing with price level changes settles down to a solution that is generally acceptable. Actually the period of time this takes will be extended or shortened in somewhat direct relationship to the degree of inflation that continues to take place. Reasonable minds will ultimately prevail and if any significant deviation exists between dollar income and "buying power" income, the latter will be recognized as important. No general adoption of any system of measurement of economic gain will occur, however, unless and until the inflationary process has advanced to the point at which it becomes recognized in the income tax structure.

Of course, new questions of accounting detail will arise. The 1999 annual meeting of the American Institute of Accountants may well contain dissertations of the subjects of depreciation rates on space ships, accounting under interplanetary monetary systems, et cetera.

All of the probabilities of change in accounting as a technique will be but a preliminary to the establishment of its greater usefulness. The end of secrecy in corporate accounts, the achievement of greater uniformity and all of the other advantages of formal principles and uniform procedures will be a preliminary to the principal objective of broadening the scope of accounting as a social force.

## Accounting as a Social Force

Once suitable refinements in accounting practices are achieved, a wholly new era of possibility will be open. With the establishment of public confidence in accounting presentations, with the assurance of reliability and comparability of reported incomes, will come for the first time the possibility of genuine partnership relationships between the classes of society under a free system. Only through such a partnership would it be possible to substitute reason for prejudice in industrial relations, and amicable discussion for violence in the settlement of differences.

It would be difficult at this time to presume to offer a formula for the division of the product of industry among the factors contributing to production. The relative evaluation of the contribution made by capital against the relative evaluation of the contribution made by labor and the relative evaluation of the guidance and direction provided by management would not be easy. Yet it is not an unreasonable goal for a true partnership in an intelligent society. It remains to be seen too whether the process of social thinking will evolve over-all agreement, on a national basis, on the division of the productive result between these creators of wealth, or whether agreement will be reached on an industry-wide level or on a company by company basis.

But these things are possible:

1. The development of a system of social accounting, showing the division of the business results as between capital, labor and management (and, of course, government).
2. An agreement in advance as to the relative evaluation as between these groups, with provision for distribution accordingly.

It is interesting to speculate how the economic "rivals" in a given industry might set about to negotiate the objective of social division. Presumably the subsistence requirements of labor and management would take some precedence over any servicing of capital or even the preservation of capital. That would be no different than it is today. These subsistence requirements would be difficult to establish and would require a combination of political evaluation, scientific studies to fix the relative effectiveness of individuals, periodic adjustment for variations in indexes of living, and so on.

However, while accounting techniques are developed, the effectiveness of accounting in social relations will be minimized until economic illiteracy among the people is eliminated. The spread of accounting education is vital to a general understanding of an industrial economy. The time will come when accounting will be a requisite in every college curriculum. There is as much need today for a knowledge of business by doctors, engineers, school teachers, and scientists as there is by businessmen.

The time will come when it will not be possible for a president of the United States to make half-true statements about the earnings of business or the costs of a wage increase or the extent of a price increase needed in an industry to retain its profit level. The public must be capable of judging for itself. For this there must be an extension of accounting and economic education in all ranks of society; for this there must be a reindoctrination of the fact that good figures do not lie; and for this there must be a respected independent accounting profession. Then there will be an understanding of free enterprise, a knowledge of its advantages, and a will to preserve it.

No one would predict that accounting alone, however well understood, could banish economic illiteracy. Specialists and economic forces will be needed to interpret accounting results. Laws will be needed to hold political actions within the rights of the people but most economic predictions now are in the realm of mystery, with greatly varying and conflicting conclusions on any given problem because of an uncertainty as to the validity of the underlying data and the absence of true scientific measurements of the forces involved. The economist needs better tools, better facts and only accounting on a grand scale can provide them. The teamwork of accounting, economics, and law seems to be what is needed to bring society into balance.

### Accounting as a Profession

It is certain that the profession which has grown from a few hundred in number at the beginning of the century to 50,000 or more at the present time will continue to increase greatly. As the profession grows in size, it will spread into smaller and smaller communities, where the pursuit of income and the exaction of taxes are no less factors in existence than they are in large cities. The profession is far from saturation and probably by the end of the century it can be expected that there will be as many practicing certified public accountants as there are lawyers, which would mean at least 150,000 or more.

There will be changes within the profession, of course. In some respects, the trend of the last several decades toward the concentration in larger accounting firms will continue because as companies grow bigger and more widespread they will need to rely upon large and nation-wide accounting practices. The possibilities for smaller practitioners will still remain, however, as long as the free enterprise system continues because within it there will always be enticement for the small businessman. There may be a trend toward specialization of service among accounting firms on the ground that an organization which is intimately acquainted with the problems of a single industry is better able to help its clients in that industry.

However, if the profession is alert, its greatest possibilities for service and gorwth will be in the development of constructive practice. This means service far beyond the routines of auditing or tax return preparation. Small business and medium-size business need help and guidance in many problems of management and finance. The science of accounting engineering is certain to be born. Within it will be all the services of office systematizing, financial interpreting, budgeting, cost control, and assistance in management decisions. Another name for it might be professional controllership, a service to hundreds of thousands of businesses which do not have available a full-time controller.

These possibilities of enhanced service will require higher standards of training for the profession. In time there will be specialized curriculums in the colleges for public accounting. Standards of education for accounting will be established country-wide in the interests of greater uniformity. Methods of screening out unlikely candidates for the profession will be adopted by the colleges as is now the case with medical students. Uniform experience requirements will exist in all the states and ultimately a single-standard of professional accountants will survive as the unlicensed public accountants are eliminated or absorbed into the ranks of certified public accountants.

As it must, there will be also stabilized regulations between certified public accountants and the other professions. Economists and lawyers will recognize that economics and law must rest heavily on the facts of accounting. Jurisdictional disputes will, in time, be subordinated to the public interest; the field of income determination, whether for purposes of business policy, taxation, government control or any other will stay where it belongs—in the hands of the public accountants.

As the art of finance and accounting continues to grow in importance, as its techniques become more uniformly established and recognized, as the number of accountants grows, so also will the influence of the accounting profession on the government increase. Accountants will play a greater and greater part in furnishing legislative guidance, in planning state and local budgets, in administering the finances of management, and in participating in management itself. The stature of accounting will grow immensely.

## Place of the Accountant

The place of the accounting in society is sure to be recognized as one of growing importance. The certified public accountant in industry, in government and in the profession will not need to fight for recognition.

Just as the profession will grow because of the growing demands of industry, so also will the number of accountants engaged in government. The time should not be far ahead when accountants will occupy all the positions connected with finance, auditing and controls in state and Federal governments. It should have happened long ago. The idea of a sovereign state having an insurance salesman for State Auditor or an architect for State Treasurer places a bit too much emphasis on vote-getting ability and not enough on efficient public service.

Accountants will become recognized for their specialty just as lawyers are and will continue to be. More and more legislative and executive positions will be available to them in all levels of government.

A notable trend of similar proportions will take place in industry. Accounting will become recognized as the best type of training for top positions in finance and management. More and more men will go to the top through the accounting route because their ability to analyze reports, trends, ratios and other significant factors is just what is needed in making administrative decisions. The same will be true of bankers and other credit institutions, life insurance companies, and investment companies.

## Conclusion

When history looks back at the period through which we have just lived—the first half of the Twentieth Century—it will probably call it the age of science. In it have been born new methods of transportation and communication; in it have come the eras of chemical synthesis and of mechanical engineering; and in it has arrived the terrifying feat of atomic fission. In terms of the tangible things of life, its comfort and its convenience, civilization has reached, both in capacity to produce and in productivity, heights which could not have been imagined in 1900. There is no reason to expect any decrease in the rate of technological improvement, in mechanization and in the output of mass production; indeed, history's most noticeable present characteristic is the continuing acceleration of its pace.

But the significance of further increases in living standards has now become secondary in terms of history to the problem of achieving a balanced distribution of these immense fruits of production. The new challenge is that of achieving a peaceful balance in human society. Unless such a balance is found, all the advantages of the highly geared production system may be risked and lost. Failing agreement to compromise, the conflicting groups among nations, peoples and classes may in time eliminate each other with the deadly forces that science has freed.

The race between science's powers of destruction and man's search for peace and security is nearing a climax. If the scientific age is to be succeeded by an age of peace, an age of leisure, or in fact by any age, it must be by an age of understanding. As it enters the last half of the Twentieth Century, human society's greatest needs are antidotes for its own inherent selfishness, jealousy, and distrust.

In a practical sense this means but one thing—a feeling of common mutuality of interest, supported by understanding and trust. There are not many ways of bringing this about. Religions have tried for centuries, without achieving a united front among themselves. Social reformers like Marx have poured eager oil on troubled waters. Emotional appeals are counterbalanced by emotional denunciations. To achieve social quiet a new catalyst is needed.

It would be useless to think of turning back the calendar to days of simpler living. Man is not willing to surrender his comforts or his longer span of life. There will be no voluntary surrender of the mechanical age for handmade subsistence living. The economics of production, consumption, exchange, and distribution cannot be avoided.

In the final analysis, therefore, the great possibility of achieving understanding in the next fifty years is through improved ways of dissemination of the "economic facts of life." Some help can come from an educational system geared to the problem. The philosophical forces of religion and the humanities can create a receptive atmosphere. Economists and statesmen can plan and develop the policies and standards under which effort and accomplishment will be recognized.

With all that, one basic ingredient will still remain to be supplied. There must be a mechanism of measurement—one that is honest, consistent, complete and therefore respected and trusted. The general acceptance of the measurement of economic facts is vital to its usefulness. In today's type of social system, that measurement can be provided only by soundly developed concepts of social accounting, with the highest level of underlying techniques and ethics. In the fulfillment of this objective lies the real future of accounting.

## SECOND SESSION

FRIDAY, MAY 16, 1952—1:00 P. M.
*The Ohio Student Union, East Ballroom*

Presiding:

CHARLES L. SCHMIDT, *President, The Ohio Society of Certified Public Accountants; Lybrand, Ross Bros. & Montgomery, Cincinnati*

Presentation of The Ohio Society of Certified Public Accountants award to highest CPA candidate in the Fall 1951 examination

Presentation of the Junior Achievement 1951 Scholarship

# PRESENTATION OF DISTINGUISHED ACCOUNTANTS TO THE ACCOUNTING HALL OF FAME

*By* George D. Bailey

*Chairman of the Nominating Board for the Ohio State University Accounting Hall of Fame*

Chairman Bailey: Mr. Vice President: The Board of Nominations of the Ohio State University Accounting Hall of Fame presents the name of Elijah Watt Sells.

Elijah Watt Sells was born in Iowa in 1858. He was reared in an accounting environment, his father being Auditor of the Treasury of the Post Office Department during the administration of Abraham Lincoln.

After attending Baker University he had extensive experience in railway accounting and auditing. Afterward he became consultant for many corporations, especially in designing and installing accounting systems.

In 1893 Mr. Sells and Charles Waldo Haskins, who was later to become his partner, were retained as accounting experts by a Congressional Commission, created to investigate the operating methods of the Executive Departments. They served two years in this capacity and their accomplishments were acclaimed by members of the Commission and by the press. The public recognition of the contribution of these two men to the work of this Commission gave impetus to the newly emerging profession of accounting.

Following this association Mr. Sells and Mr. Haskins formed the accounting partnership which has continued to bear their names.

For two years, 1906 and 1907, Mr. Sells was President of the American Association of Public Accountants. Later he took an active part in the organization of the American Institute of Accountants, serving on its Council and Executive Committee.

He had a deep conviction that the profession should be founded upon high educational standards, and he participated in the organization of New York University School of Commerce, Finance, and Accounts.

Mr. Sells was one of the early advocates of publicity of corporation accounts and lived to see his hope develop into a realtity.

He was Senior Administrator of the firm of Haskins & Sells for twenty-one years before his death in 1924. In this capacity he was ever conscious of the new challenges to the profession which were being demanded by the increasing complexities of industrial processes and business organization.

The accounting profession was founded on public service and social responsibility. To the founders with this high perception and rare vision we recognize a great debt. As one of these founders the Nominating Board of the Ohio State University Accounting Hall of Fame is proud to present Elijah Watt Sells.

VICE PRESIDENT TAYLOR: Mr. Queenan: In recognition of the outstanding contributions to the development of the accounting profession by Elijah Watt Sells, upon the recommendation of the Board of Nominations and under the authority of the University, I have the honor to inform you that the name of Elijah Watt Sells has been placed in the Ohio State University Accounting Hall of Fame. In testimony thereof, I present this appropriate certificate duly signed and with the official seal of the University which is now presented to you as a representative of the firm Haskins & Sells with which Mr. Sells was actively associated during his distinguished career.

JOHN W. QUEENAN: I accept this certificate of award as evidence of honor to the memory of Elijah Watt Sells on behalf of my partners and associates in the firm that Mr. Sells founded with Charles Waldo Haskins. We are as sensitive to and gratified by this honor as, I am sure, Mr. Sells himself would have been, especially as the Accounting Hall of Fame, sponsored by this University which has contributed so much to the profession of accounting, is symbolic of the fulfillment of his dream of an accounting profession which would be a prominent and respected element of the economy of the country. He would have regarded it as a privilege because this particular Hall of Fame is based on the continuing development of the profession and not merely on its historical record.

Mr. Sells is truly a pioneer in accountancy. With other men of like stature, he contributed unstintingly of his time and his talents toward the development of the accounting profession as we know it today. His work and achievements as an accountant are well known, and yet he is remembered best by those who knew him well for his fine personal qualities and his rare breadth of vision. He was a gentle, modest man with little desire for fame, but with a definite gift of inspiration which seemed to develop the best qualities in those who worked with him.

Mr. Sells foresaw the important role public accounting would play in the economy of the country. His efforts were constantly directed toward that goal. He knew and preached that the profession would attain that goal only by constructive service to the financial community. He recognized that this entailed not only skill in practice, but also integrity and absolute independence. He recognized too the need to encourage young men to enter the profession and to properly train them, as evidenced by his participation in the establishment of the School of Commerce, Accounts and Finance of New York University. He lived to see many such collegiate schools established, and, I am sure, he would be deeply gratified if he were here today to see such schools as Ohio State, whose graduates are constantly adding to the stature of the profession; six of those graduates are now partners in his firm.

Mr. Sells' deep interest in young men preparing for a career in public accounting was recognized by some of his friends, who upon his retirement from the Council of the American Institute of Accountants established the Elijah Watt Sells Scholarship Fund, which provides the awards made each year by the Institute to the candidates attaining the highest standing in the CPA examinations.

Mr. Sells had a high sense of public duty, which he regarded as essential in a professional man. It is perhaps in this connection that the breadth of his vision is most clearly indicated. In an address at a meeting of the New York State Society of Certified Public Accountants in January 1915, two years before our entry into World War I and five years before the discussions with respect to the League of Nations engaged the attention of the civilized world, Mr. Sells suggested a detailed plan for international peace based on the establishment of an independent tribunal endowed with the right to adjudicate international differences and provided with the power to enforce its decisions.

If Mr. Sells were here tonight he would accept this award with grateful humility, considering it primarily as an honor to the accounting profession he regarded so highly and labored for so diligently.

Chairman Bailey: Mr. Vice President: The Board of Nominations of the Ohio State University Accounting Hall of Fame presents the name of Victor Hermann Stempf. Victor Hermann Stempf, born in Minneapolis in 1893, received his educational training in accounting at St. Louis University. He became associated with the firm now known as Touche, Niven, Bailey & Smart in 1915, becoming a partner in 1922. In 1927 he moved to New York City where he practiced until his death in 1946.

From the date he became a Certified Public Accountant in 1917 until his death, he served the profession for the comparatively brief period of twenty-nine years. This was a period in the history of this nation which presented the greatest challenges to the accounting profession—the First

World War, the expending economy of the twenties, the depression of the thirties, and the Second World War with a forward look to the post-war problems.

That Mr. Stempf met these challenges is evidenced by his record of notable achievement. He served as President of the New York Society of Certified Public Accountants, President of the National Association of Cost Accountants, President of the American Institute of Accountants, Vice-president of the American Accounting Association. In addition to these offices he was a member of many committees of the American Institute of Accountants—Committee on Accounting Procedure, Committee on Federal Taxation, and he also was the accountant member of the Committee on Post-War Tax Policy.

He wrote numerous articles, delivered many addresses before accounting groups. These contributions have been collected and are being published by the American Institute of Accountants.

He was one of the early enthusiastic supporters of the Ohio State University Annual Institute on Accounting. He appeared on the first program in 1938 and also the programs of 1940 and 1944.

As an eminent practitioner and as a writer, Mr. Stempf was constantly searching for certain basic principles upon which the work of the professional accountant should be based, especially during periods of changing price levels. His objectivity of approach, his penetrating analysis, and his genuine modesty were deeply admired by his colleagues. He was tolerant with those with whom he differed on accounting principles and procedures but uncompromising on questions of professional ethics and conduct.

To Mr. Stempf accounting was a public trust. To this belief he devoted his entire career as a Certified Public Accountant. It may be truly said that to this belief he gave his "last full measure of devotion."

The Nominating Board of the Ohio State University Accounting Hall of Fame is proud to present Victor Hermann Stempf.

VICE PRESIDENT TAYLOR: Mr. Mendes: In recognition of the outstanding contributions to the development of the accounting profession by Victor Hermann Stempf, upon the recommendation of the Board of Nominations and under the authority of the University, I have the honor to inform you that the name of Victor Hermann Stempf has been placed in the Ohio State University Accounting Hall of Fame. In testimony thereof, I present this appropriate certificate duly signed and with the official seal of the University which is now presented to you as a representative of the firm Touche, Niven, Bailey & Smart with which Mr. Stempf was actively associated during his distinguished career.

Henry E. Mendes: It is indeed an honor, of which I am deeply appreciative, tempered with a feeling of extreme humility, to be here this evening to receive in behalf of my firm this Award to our late partner, Vic Stempf. My one regret is that Vic is not here in person to accept it and participate in the proceedings. I have reason to believe that this sentiment is shared by all present at this gathering.

Anyone whose good fortune it was to have been acquainted with Vic will agree that he would be here but for the fact that he gave so unsparingly of himself, both to his firm and his profession, during his active career—the cause, in a large measure, of his early demise. However, I know that he is here with us in spirit and in commemorating him we reflect credit on ourselves.

Having been associated with Vic for the entire period—almost 31 years—of his accounting career, a most intimate relationship developed, quite naturally, between us and I feel particularly well qualified, therefore, to testify without reservation to his sterling qualities and genuineness of character. As many know, he was a wonderful, dynamic personality, gracious and most-understanding at all times—an inspiration to all who met him.

I first met Vic a few weeks after his graduation from St. Louis University—he received the degree of B.C.S. upon completion of the course in Accountancy and Business Administration—when he was engaged as a junior on the staff of the St. Louis office of Touche, Niven & Co., which office had been opened under my supervision early in July of 1915. As a matter of fact, he was the first one engaged for the staff, having been referred to us by a prominent St. Louis banker who was a lecturer on finance at St. Louis University. For several years immediately prior to his coming with us, Vic had held a position of responsibility in the Statistical department of the Bell Southwestern Company. Right here, I believe that it is not inappropriate for me to mention, in all modesty, that the first public accounting work Vic performed was under my direction—it was an assignment from our Chicago office covering the accounts of certain enterprises for the receivers of an important railroad.

It was not very long before Vic was placed in complete charge of engagements, his tenure as a junior, as it were, having been rather short-lived. Vic's progress was very rapid so that, about the middle of 1919 when the firm decided that I should move to Cleveland to open the office in that city, there was no question whatsoever as to who should succeed to the managership of the St. Louis office; as mentioned in the citation, Vic became a member of the firm a few years later—in 1922.

I could go on reminiscing at considerable length about Vic but I realize that this is not the purpose of my being here. Suffice it to say, by way of conclusion, that his untimely death in April, 1946 was a great shock to his family, his friends and his partners, and to all others who knew him well. In his passing, I not only lost an esteemed and valued partner but, also, as well, a most loyal, devoted and genuine friend.

## THIRD SESSION

FRIDAY, MAY 16—2:30 P. M.
*The Ohio Student Union, West Ballroom*

Presiding:

HERMAN A. PAPENFOTH, *President, The National Association of Cost Accountants; Manager of Finance, Trumbull Electric Department, General Electric Company, Plainville, Connecticut*

Address: "Are Our Concepts of Internal Control Antiquated?"

H. C. M. COBB, *President, The Institute of Internal Auditors; Assistant Controller, Worthington Corporation, Harrison, New Jersey*

Address: "Capital Formation Today—Prosperity Tomorrow"

KENNETH R. MILLER, *Business Manager and Treasurer, National Association of Manufacturers, New York City*

Address: "Financial Administration in New Mexico"

EDWARD M. HARTMAN, *State Comptroller-Budget Director, Santa Fe, New Mexico*

# ARE OUR CONCEPTS OF INTERNAL CONTROL ANTIQUATED?

*By* H. C. M. Cobb

*President, The Institute of Internal Auditors; Assistant Controller, Worthington Corporation, Harrison, New Jersey*

When did you last take a look at your system of internal control? Are you satisfied that it is both modern in its concept as well as in its application? I do not mean just one portion of your internal control, but the whole thing. Are you satisfied that everybody in your company understands what it is, from the president on down through the organization? I think if I stopped at this point and allowed each and every one of you to give his answer to these questions, you might be very much surprised at the variety of answers, at the various interpretations of what it is, and in the admissions that undoubtedly many people throughout industry do not fully understand its true implication, and yet internal control is an expression that is widely used in all levels of business.

Undoubtedly, its most common use is amongst auditing and accounting people and I think that the top management of many companies consider it as an expression applicable to those occupations, and while using the expression often, do not understand it. The fact that they should seems obvious, for to many it implies one of the most basic elements of carrying on a business as basic as that of buying and selling and of making business decisions.

Now if you agree with me to this point, then I think you must also agree that it is absolutely essential that people in the accounting and auditing profession understand what we are talking about and the true implications of this term as it affects the business world, so that we in turn can pass along our understanding to those in all levels of business so that it can be put into practice in the most efficient manner.

While too, I think that "Internal Control" is becoming one of the most used pair of words in the accounting and auditing professions, yet it is one on which I think there is almost as much disagreement as to its true meaning as there is laxity in its use because of the lack of understanding of its meaning. This is based on my own observations and discussions with many people in different parts of this country and in different departments of the business world who are vitally interested in this subject. Predicated on these assumptions, I believe this is of more than academic interest to all those who are interested in control of any sort, so I will try to review for you the various aspects of the problem and to leave with you some objective thoughts for you to take home and think about.

## The Origin

Business in this country has been gradually growing more complex as the economy of the country has been reaching for higher planes. The standards of yesteryear are no longer acceptable. With this growth in complexity, management is gradually being forced to delegate more of its authority in order to properly discharge its responsibility. In so doing, it has been necessary for it to set up controls which would act as a medium in assuring it that the delegation of its authority was done in a manner to further the best interests of the business and, at the same time, to make sure that the delegation was in fact serving to properly discharge its responsibility.

When a business could be managed on a single direct line basis, the elements of control necessary to achieve the proper discharge of responsibility were probably little different than they are in large business today, but by being centralized in one or two individuals, they did not appear as complicated, because of their directness and the centralization of authority and responsibility. The growth in size and complexity, therefore, brought about the first requirements for delegation of authority and with it the need for controls.

Undoubtedly, the first step along this line was organization. The delegation of authority required some one to delegate it to and a division of the authority in such a manner as to achieve the responsibility of management in the most economic manner. There has been much written on this subject and many and varied opinions given as to the best type of organization in a given set of circumstances. I will not attempt here to discuss them, because that in itself could form the basis of many hours of talk and discussion. Suffice it to say that this is undoubtedly one of the major items of control and an integral part of any management plan in doing business.

Another of the early controls was accounting and record keeping. It provided a means of telling the management whether it was operating in a manner to discharge one of its principle responsibilities—that of making a profit. In its simplest form, this was merely a showing of the excess of cash receipts over expenditures, which is still used in many smaller businesses. This is indeed a far cry from the complex accounting which is used in modern big business today, when it is used not only to provide historical reports on management's discharging of its profit responsibility, but also in many other areas, such as protection and conservation of assets. At the same time, it provides current controls for these times and a basis for future control through forecasts, budgets, etc.

As the complexity of business increased and it grew in size, it became necessary to institute further controls through policies and procedures which would also guarantee a measure of control over the delegation of authority. As we all know, the bigger and more complex a business becomes, the greater the necessity for controls.

One of the growing forms of control are standards of performance which are established for many areas of the business, the best known of these are standard costs and budgets, which, while being applied by the accounting department, are used by many departments of the business; in addition to these are profit standards and standards for labor, both direct and indirect. The field for the application of standards of performance is a growing one and an essential part of the whole control picture.

The youngest of the control mediums is internal auditing, which provides management with a report on the workings of the business and evaluation of the adequacy and propriety of other forms of controls. This medium of control is growing rapidly, particularly in larger companies where it is providing virtually the balance wheel of the control program in that it can complement and supplement the other forms of control.

## The Elements of Control

These, I believe, constitute the five main internal control mechanisms used by business today and some of the basic reasons for their institution. Now, if you agree with me so far, let us explore in more detail what they are accomplishing, so we can better understand why there is a general misunderstanding as to the nature of internal control.

Management, by delegating its authority, delegates its right to make decisions, and this may go down all the way until a job is reached where no decision is necessary. This management prerogative is translated into action and from action into results. Now, basically, it seems to me, the controls that management institutes are such as to limit the degree of decision at any one point, and, at the same time, provide a basis to evaluate the effect of the decision and resulting action in terms of their effect on the discharging of management's responsibility. I hope this is clear because I believe that it is this basic broad conception which is not fully understood and causes resulting confusion in talking about controls and their narrower conception.

Let me give you a concrete example.

Top management decides that it is going into the business of manufacturing and selling parking meters. In making this decision, it ascertains that:

1. It is a good field for the company to get into from a sales, manufacturing, and economic standpoint.
2. It can manufacture a satisfactory product at a cost at which it can sell at a profit.
3. There is a sufficient market, etc.

To this point, there has already been the exercise of decision and control. Next comes delegation of authority. It goes into the business and at each step along the line three elements of decision, delegation and control are exercised to achieve the common end. First the organization is set up, then the policies and procedures are developed, and, as action the plan develops, accounting takes over to make record of the progress and to control the carrying out of the plans.

Let us extend our example to show some of the next steps along the line.

A decision must be made as to whether the operations will be handled by a separate organization, either subsidiary or division, the location of manufacturing facilities, the type of selling organization, through a company sales organization or a dealer organization.

Decisions may be made to centralize the accounting, billing, and collections, but to maintain field stocks of parking meters and parts. These decisions may or may not require changes in existing controls as the accounting operations may already be centralized. However, let us assume that the keeping of field stocks is something new. Adequate controls must be set up for proper storage, inventory ordering, shipping, etc., so that the delegation of these functions may be properly controlled.

Standards of performance on manufacturing, for labor costs, and profits, are set up to judge the performance of the operation. Finally internal audits are made to see that the controls are adequate and working.

One of the elements of each form of control has been the system of checks and balances with which accountants are so familiar. However, I am afraid that many in talking of internal control stop there. I think you will find in your dictionary a subtle difference between checking and control, and that is the element of direction and guidance that is part of control, but not of checking. Now each form of control has some of each element and I think it is important that we recognize them, so that in talking we differentiate between internal control and its part, internal check, and, through better understanding ourselves, we can help others understand.

One of the most difficult things to understand is the impact of timing and degree in controls. As a practical matter in big business, there is very little action of any kind that is not subject to some form of control at some time. The question is mostly when and to what extent. The extent is easier to answer than the when, as certainly no control is worth its salt that costs more than the value of the decision or action that it controls. However, the "whens" are often harder to decide and subsequent checking will give a good indication whether it should have been sooner or not. Very often the answers are decided in the light of experience, and more often than not, sad experience. Undoubtedly, a great portion of the controls that have been instituted in modern business have been adopted because of losses, fraud, or for some other smaller reason. Undoubtedly, such new controls might have been adopted before, if it had not been felt that the eventuality of the sad experience I just referred to was discounted and it was felt that the control was too costly.

Now, one of the principal proponents of controls has been the accountants and in many companies this phase has been delegated to them almost in its entirety, with the result that other departments have only been interested to the extent that they have been educated in it, and some of the education has been a little "muddy." Our friends, the public accountants, have done much to publicize the importance of controls. In fact, their statement on internal control was the first such statement on this important subject. It was a good statement and I think pointed up the problem. But I think that nevertheless it was by its nature, chiefly concerned with public accounting, and rightly so.

However, I believe that management and industry too, should be fully cognizant of these controls they have created, and understand in all its branches the implications of each. I think it is just as important for the president of a company to understand these implications as it is for the manager of some small branch; in fact, anybody who makes a decision should understand this tool which he is using, as it is only by fully understanding what undoubtedly represents an important tool in carrying out his job, that he can do the most effective kind of job for his company.

The exercise of decision goes far down the line or organization as authority is delegated until a point is reached where little or no individual judgment is no longer required. Even after that point is reached, control must operate to assure that the operations are being properly performed. The girl doing filing is operating under control with little or no individual decision, and yet consider what might happen if she were improperly instructed and filed everything incorrectly. It would not be long before the departments affected would be in confusion, too. However, time is a very important factor, and limiting control must be effective in shorter time as individual decision decreases in importance. The decisions of the president may not be evaluated until a year or two after they are made, but that of the small department head may be evaluated in a month, week or even sooner.

Now, why is the full understanding of internal control so important? Because, as I believe, it is such an important part of our daily lives. I have talked about the responsibility of management. Let us consider, for a moment, what it is. It is, I believe, the responsibility of carrying on a trade or business at a profit which will give a fair return to the investors or owners of the business and will contribute to the advancement or maintenance of the economic level of the society. The areas of discharging this responsibility are basically planning, carrying out those plans, and making an accounting of the results. In these areas, I believe, run three main factors —decision, delegation of authority, and control, and these three factors are present in all three areas of the discharge of responsibility. So that control, in which we are presently interested represents, I believe, one of the important factors of which both direction and checking are a part. As it is tied so closely to the basic elements of business management it is natural and necessary that we should try to understand it fully and we all have to apply its principles in our daily activities. As it is so basically a management function in a delegation of it, we must strive to understand management's conception and purpose in its creation in our particular situation.

Internal auditing is to some degree the balance wheel of internal control and serves to compensate the other forms of control while evaluating their operating efficiency, so that internal auditing may be called in anywhere along the line to appraise and evaluate the controls and see that they are working and adequate, and that decision and action are not being made without adequate control.

There it is, as simple as that in principle, but the more complex and larger the business, the more complex and extensive are the controls. *The problem is, of course, in degree and time. We must be sure we are neither going too far or not far enough, that we are not doing now what should be done later, and vice versa.* How can we do this? Firstly, by a study of the problem in our own and other companies, for a better understanding of control, what it is, what it does, and how and why. Secondly, by a study of failures, what caused them. Theoretically at least, it should take some undue circumstances like acts of God, general depressions, wars or other unforeseen events to make a business go sour, but we know it happens every day all over the world. Why? Because of some failure in the control mechanism itself or failure on the part of the individuals who hold delegated authority. Thirdly, by better understanding and communication by groups who are responsible for control in both management and professions.

One of the most difficult obstacles in the path of the average internal auditor is to convince management that he has a service to offer, particularly on technical and semi-technical operations. There has been a striving on the part of many to add men with technical experience to their staffs to overcome this obstacle. Sometimes it works, more often it does not. It is like outguessing the experts, and the odds are all against winning by a part time technician. I think sometimes this struggle is both useless and unnecessary, when the obstacle can be surmounted in an easier fashion. What management is interested in is control. Is there adequate control judged by results and common business sense? If the auditor can demonstrate that control is absent, then I do not think management will lag behind in providing whatever technical assistance is necessary to provide control.

I think internal auditors everywhere have an unparalleled opportunity in this field of control. While they have no direct authority with respect to the establishment of controls, they are themselves a basic part of the control mechanism. They have the opportunity to see it working in all of its phases, to comment on its efficiency and adequacy, and to report to management with both criticisms and suggestions. They have an opportunity for study of the subject in collaboration with other groups.

The Committee on Internal Auditing Principles and Practices of the Institute of Internal Auditors has been studying the subject of internal control for the past year. In this study they have, of course, been greatly assisted in the study made by the American Institute of Accountants. This study has been one of free thinking. Sitting in on this committee, as I have done, I have heard many of the thoughts that I have tried to put before you in this paper discussed pro and con. It is a study which I hope will be able to be presented to internal auditors everywhere for their further thought and comment. After many of the doubts have been cleared away and the thinking crystalized, maybe it can be submitted to the professional and industrial people for their critical analysis. It is our earnest desire that in so doing it will enable people everywhere to have a better understanding of just, thorough, and critical thinking of it.

Better understanding of this problem by everyone concerned will help to decrease business losses and assist management to maintain more effective control.

# CAPITAL FORMATION TODAY—PROSPERITY TOMORROW

*By* KENNETH R. MILLER
*Business Manager and Treasurer, National Association of Manufacturers, New York City*

It was particularly gratifying to have Mr. Miller, Chairman of the Department of Accounting, suggest that the topic of capital formation might be of interest to you gentlemen, particularly so in the light of current conditions and those factors which currently and in the future can have a serious effect on the formation of capital.

Unfortunately, although you gentlemen fully understand what is meant by capital formation, a great many other people have only half an idea of what it means and some have no idea at all. It is apparent, part of the general public gives to this term, capital formation, a connotation that is much different that it has for us. Some of them see in capital formation the massing of huge aggregations of capital into some awe-inspiring Frankenstein that threatens to engulf the nation and everything in it.

While we may laugh at this, we must not forget that in recent years, the American public has been subjected to a great deal of poison,—and a distrust and hatred of capital is one of these poisons. Hence even the use of the term capital formation is very likely to play unfavorably upon the emotions of a great many people even spilling over into political currents. It is therefore imperative not only that we understand its meaning but more important that we have a reasonably detailed appreciation of the actual processes and its relationship to economic survival and progress. If we can get just a few simple facts and truths into the public mind, perhaps we can have less reason to be unduly concerned about the days and years ahead.

For example, it is highly desirable that it be generally understood that full employment or high level employment alone is not enough—that this condition must be accompanied by high level production. When you have this combination of high employment and high production, you then have an economy doing its job of supplying the people with a maximum supply of goods. When people realize that it is production of goods that benefits the nation and not just full employment without consideration of production, then it becomes considerably easier to understand the full meaning of capital formation. It is then easier to convince people that capital formation not only gives present employment but that it provides the means for future productivity of labor.

What do we mean when we refer to the term, capital formation?

The most widely accepted measurements are based on separate estimates of four distinct classes of production. All possible items of capital formation are assumed to be included under these four. They are:

1. Producers' durable goods.
2. Construction.
3. Net changes in inventories.
4. Net change in claims against foreign countries.

In the final analysis, that part of production which is used to facilitate future production is called capital formation. The remaining share of the output of goods and services which is applied directly in satisfying human wants is called flow of goods to consumers. So you see, capital formation is as much a technological as an economic process and strangely enough there is not anything new about it. It has gone on in all stages of history from the first savage when he took time out to make a bow and arrow in order to facilitate and to increase the productivity of his hunting.

It has been carried on in all forms of economic organizations; Feudalism, Socialism, and free enterprise. In all ages and societies, its purpose is the same—namely, to increase the effectiveness of labor and thereby to raise the output of the goods and services people want. Therefore, it is not the accumulation of sums of money but rather the production of goods and services, tools, machinery, equipment, and construction that result in an increase in the production of consumer goods.

Many years ago—1859 to be exact—the great Lincoln referred to this process in a memorable explanation of the American system. Said Lincoln:

> The prudent, penniless beginner in the world labors for wages awhile, saves a surplus with which to buy tools or land for himself, then labors on his own account for another while, and at length hires another new beginner to help him. This, say its advocates, is the just, and generous, and prosperous system, which opens the way for all, gives hope to all, and energy, and progress and improvement of condition to all.

Note Lincoln's phrase *saves a surplus with which to buy tools or land*. Those are the key words—the words that spell the development and progress of both an individual enterprise and of a nation's entire economy. Without that surplus—without the creative capital that makes possible the more and better tools for better tomorrows—enterprise is neither free or enterprise; it is little more than a slave to the present. Those words were true when Lincoln uttered them almost a hundred years ago and they are true today.

If we are to have a strong and prosperous nation, American industry must have a steady supply of capital funds with which to produce the machines and plants that in turn produce the ever-increasing supply of goods. There is no other road to soundly-based prosperity. Informed and reasonable men of whatever economic persuasion do not attempt to deny this elementary principle of productive enterprise. They know it cannot be refuted. They are aware, too, of the striking fact that between 1869 and 1928, an average of 20 per cent of our gross national product was devoted to capital formation.

They know that this led to an eight-fold increase in production—an average of 3.8 per cent per year, compounded annually. During the same period the productivity of labor was doubled because the workers were given more and better machinery and tools. At the same time labor's real wages—purchasing power—doubled. The amazing wealth and strength of the United States today is eloquent testimony to the creative power of capital formation over the decades since the days of Lincoln. No matter what great economic development one studies—industry, mining, transportation, trade—every one of them required that a part of current production be set aside in order to build for a still greater future. Without an adequate supply of new capital and the daring enterprise of free men, the greatest inventions and discoveries would die a-borning. Studies reveal that in almost every line of industry for which adequate data are available, the rate of increase in production is proportional to the rate of increase in capital; and the more rapid the growth of new capital the more rapid the development of the industry.

There are a number of ways in which to test the validity of what I have been saying about the vital role capital formation played in the development of the United States. But there is one simple illustration. Remember, I pointed out that in each ten-year period between 1869 and 1928, an average of twenty per cent of our gross national product was devoted to capital formation. I need not remind you that these years from 1869 to 1928 were ones of unparalleled economic and industrial growth. The face of our nation was changed while the world was astonished by the extent to which the American standard of living was lifted to successively higher levels.

Now, bearing in mind our steady and tremendous economic progress between 1869 and 1928, and recognizing that at the same time there was a consistent putting aside of a substantial part of current production to facilitate future production, consider then what happened *after* 1928. Well, even the youngest ones here know that a terrible depression began in 1929 and plagued the land until the defense and armament activity of World War II began.

But—and this is the important but usually overlooked fact—during the nineteen thirties our economy suffered a serious drop from the historic average of twenty per cent of gross national product set aside for capital formation. Between 1929 and 1938 less than 14 per cent of the gross national product was set aside to increase future production. In not one of the years from 1929 to 1938 did capital formation reach the historic one-fifth of national output. It was the first decade since the Civil War that our level of production failed to advance. Obviously, there is an inescapable relationship between capital formation and prosperity—and the lack of capital formation and depression.

It is interesting to recall that as recently as June, 1948, the *London Economist*, contemplating the melancholy outlook for England's private enterprise, remarked, and I quote, "It would be going too far to say that the standard of living of a nation depends solely upon the productive capital it possesses; but it certainly depends on that much more than on any other single thing, or even than on all other things put together. . . . There are very few votes in it. Yet the penalties for neglecting it, though they may take some time to mature, will in the end be inexorable. . . . By any test the British economy of the inter-war years was creating far too little capital."

When one thinks of England's sad plight today, and when one recognizes that her economic disintegration was engineered by a group of skillful but quiet-working socialists, then one must conclude that the drying up of productive capital in England was no economic accident or trick of fate. It was simply a socialist adaptation of the Marxian thesis that the way to destroy capitalism is to destroy capital.

So much for the past. Now—what of the present? May I first refer to current income tax rates. I should like to mention the importance of thinking of the so-called Excess Profits Tax as being the seizure by Government of retained earnings that to a significant degree would otherwise go into capital formation. Thus, the Federal Government today is effectively putting a brake on tomorrow's stability and progress. The soundness of this unhappy conclusion is evidenced by the fact that prior to the reimposition of the Excess Profits Tax, American business found it necessary to retain a good part of earnings to finance the great post-war expansion.

What is the prospect ahead of us with respect to taxes?

Well, the word out of Washington this week is that there is now some feeling on the part of the Administration that current high tax rates could be deflationary even to the point of causing a recession next year. They are rightly concerned because the latest figures on profits show that in spite of a 17 per cent rise in sales, there was a 24 per cent rise in taxes from 1950 to 1951, so that business has had less profit and less funds available for expansion or replacement that makes jobs. Apparently, there begins to come a realization on the part of some of those in Washington that by letting the Excess Profits Tax expire and by lowering regular rates on corporations there might be a stimulation of business activity.

Concurrently, there would have to be a reduction of individual rates because they cannot overlook the fact that the current excessive individual income tax rates have had the effect of eliminating substantial sources of venture capital and other funds which normally flow into the business stream.

Now what about profits?

Our President, Wm. J. Grede, in testifying before the House Banking and Currency Committee on the proposed extension and amendment of the Defense Production Act on Tuesday of this week had this to say:

An illusion is that *profits are merely a necessary evil which perform no useful service in our economy*. According to this attitude, profits can be justified only by reference to the outworn principle of private property. *The truth is that profits perform an indispensable function—the function of allocating capital, manpower, and natural resources among the several alternative purposes for which they might be used*. Only the firms which can operate efficiently enough to sell below the price set by the costs of the marginal producer can command labor and materials. Capital seeking investment flows naturally into the fields where it can be most useful—that is, into the most profitable fields. Even a socialist economy—if it were to function at all—would have to compute the 'profit' on each enterprise and allocate its resources accordingly.

*Another common illusion is that profits, after they are earned, do not flow into any channels where they serve useful purposes*; that it would make no particular difference to the economy if these profits were not available.

Actually the availability of profits makes a great difference to our general well-being. In the post-war period, retained profits have served as an important source of capital for expansion. It is industrial expansion which provides new jobs and new products, improves our standard of living, and lays the base for our military power. Looking ahead we see the need for a great amount of capital if we are to to maintain and increase our standard of living and provide jobs for those people who will be added to the labor force. It is estimated that the 'normal' increase of the civilian labor force will amount to about 1,200,000 annually between now and 1960. Thus, by July, 1960, the labor force is expected to show an increase of 10,263,000 over 1951. It is well known that a great amount of venture capital must be generated to provide the investment funds for so many jobs. Latest estimates indicate that to provide a single job in manufacturing industries requires an average of about $11,000.

Taxes paid out of corporation profits have amounted to over $90 billion in the years since 1945. If profits had been lower, the Government would have had to get this amount from some other source. The funds provided by post-war profits have flowed into channels so important that, if these profits had not been available, some substitute source would have had to be found.

A McGraw-Hill survey of industrial spending for new plants and equipment points to record expenditures for 1952, but the big question is what will the picture be when defense spending tapers off? There appears to be considerable difference of opinion about this. One question is the extent to which we have actually increased productive capacity in the post-war period as a result of our capital expenditures. There are two fairly recent estimates.

The first is by the Department of Commerce which indicated that the physical volume of production at the end of 1951 was slightly more than 40 per cent above the volume at the close of 1945. While the physical increase in gross capital assets is not necessarily identical with the increase in productive capacity, the two are closely related. The second estimate comes from the McGraw Hill survey which indicated an increase for all manufacturing over the six years of 1946 through 1951 of 43 per cent.

So, you see— there is substantial concurrence of two different estimates arrived at by completely different methods. According to the Machinery and Allied Products Institute, we have had an increase in manufacturing capacity over the post-war period averaging about 6 per cent per annum compounded, and it would appear there would be a further increase of 8 per cent in 1952.

This rapid expansion raises some interesting questions, one of which is, can the output made possible by this expansion find a new market when military buying is reduced? Time does not permit a thorough-going discussion of this $64 question and I would only relay two interesting points of view. Dr. Eli Shapiro, Associate Professor of Finance at the University of Chicago's School of Business, feels that we have underestimated the need for plant and equipment in this country. At a recent meeting, he said:

> Over a period of 25 or 30 years, if you take the relationship of plant and equipment expenditures to population and so forth, we could continue to expand at current rates for a long time and never get excessive plant capacity, as judged by historical standards.

Joseph F. Davis of the Food Research Institute of Stanford University, has recently issued a document with respect to population trends in which he said:

> Huge private and public investments will be required to cover the requirements of a population growing at a considerable (if not extremely rapid) rate, with unprecedented numbers now under 10 years of age, and with rising consumption

standards in food, housing and recreation. For the time, defense requirements are compelling diversion of investment, and arrears are building up as during the war, through on a smaller scale.

Failure of investment demand was feared as a source of severe economic difficulties in the United States, including chronic large-scale unemployment and huge government spending to keep up aggregate demand. By contrast, our post-war problem has been one of excessive demand, making for inflation, and our population growth coupled with our world responsibilities bid fair to make this the more serious problem in the next decade.

The surprising recent population growth has been a major factor, reinforced by higher real-income levels and moderate hours of labor, in expanding public and private investment since the war in roads, water and sewerage systems, gas, electricity, and telephone lines, private manufacturing plants, transportation equipment, housing, and private automobiles. The rearmament program is distorting and on the whole restricting such investments for the present; but the maturing of the huge group of persons now under 20, which can be reasonably forecast, gives reason to expect strong continuing demands for such investment after arrears due to wartime restrictions and the current defense program are made up.

I would be remiss if I did not point out the problem with respect to capital expenditures for modernization purposes about which there is so much talk now.

As the Journal of Commerce said recently: "When there is need, most industry usually hasn't got the money for them or hates to take the risk of straining its financial position. The time for such expenditures logically is at the top of a boom when business is good and profits are large. That would be now were it not for high taxes and material shortages."

So the question as to whether or not capital expenditures for this purpose are likely to be actually higher or lower than current estimates is one for which there can be no immediately effective answer. Certainly American industry has plans in the works which given the financial resources to carry them out will prevent the shock of the reduction in the defense program. The question is what they will actually do.

Fortunately, more companies are planning on a long-term basis and this will have the effect of dampening the sharp swing in capital investment. One cannot discuss the problem of capital formation without commenting upon the notorious seizure of the steel industry by the Government. I shall not attempt to discuss the Constitutional angles since those are already in the hands of the learned Counsel and the Supreme Court of the United State.

I would point out that the seizure of the steel industry amounts to an unconditional surrender by government to the unions; surrender to the reckless idea that there's no harm in sabotaging a company's or an entire industry's financial structure so long as it confers a benefit—however brief —on employees. The government's desperate attempts to impose upon the steel industry a substantial increase in wages without allowing a corresponding increase in prices is obviously inequitable, arbitrary, a dangerous precedent, a pattern for other unions to follow, and possibly unconstitutional.

However the greater evil about the seizure is that it is an attempt by government to transfer wealth from one group of citizens to another. It is a transfer of a part of the earnings of the steel industry from thousands of owners of that industry to the employees of that industry. Call it what you will, it is still a form of stealing. If it develops that the government is to be allowed to affect such a transfer of wealth from the owners to the employees of the steel industry, it is not difficult to imagine the tremendous pressure that will be built up to do the same in all other industries.

That, of course, could be the end of free enterprise in the United States. If profits are going to be continually squeezed between high wages and high taxes, then investors will stay away from American industry in droves. However, this reckless thinking and conduct by Government and the union leaders would stop overnight if enough Americans understood the harm it can and will do if not stopped.

Our productive supremacy primarily stems from the fact that American industry is heavily capitalized. Before a man can get a job or do a job, the employer must put behind that worker money, machines, material, and management. In the manufacturing field alone, approximately $11,000 per worker had been invested at the beginning of 1952. Moreover, in a dynamic economy, new capital is always required to create jobs as the labor force increases, to replace obsolete and used-up equipment, and to meet competition through greater productivity.

But capital is always in limited supply. Free enterprise has never found it easy to secure all the capital it needed, and often it has failed to obtain capital. The fact we must face today is that industry's quest of new capital—a quest that must be successful to insure the future—will become practically hopeless if profits remain the victim of confiscatory taxes, price controls, higher wage demands backed and pressured by Government, threats of Government seizure, and whatever else the enemies of capitalism and their puppets can devise.

As accountants you men can exert a great deal of influence with the general public on these vital questions. Your mastery of complex financial matters is as readily accepted by people as is your devotion to the record—to the unadorned facts.

If you can inspire such public confidence—and I am sure that you do—then you should be able to get across to these same people the kind of basic economic thinking I have been talking about. If we can get the American people to realize the contribution capital formation has made to their well-being, and what it means to the continued strength and prosperity of the nation, then we could look with confidence to the days and years ahead. We would then have little or no fear about the lack of tools, machines, houses, ships, and other material and equipment necessary to meet the needs of an expanding population and to lift the American standard of living a few notches higher.

The seriousness of this whole problem is underlined by the fact that there is no alternative to capital formation if we are to retain the system that has given us both freedom and unparalleled material abundance. We either preserve this system and capital formation, or we continue to cripple the formation of capital and thereby make easy the collapse of Capitalism and its replacement by some form of Socialism.

I know you share with me the conviction that for America there can be only one answer: The continuance and the strengthening of the marvelous system that has made our nation great and her people prosperous in the midst of freedom.

# FINANCIAL ADMINISTRATION IN NEW MEXICO

*By* Edward M. Hartman
*State Comptroller–Budget Director, Santa Fe, New Mexico*

This is a homecoming for me. Just twelve short years ago, I attended the Ohio State University Accounting Conference as a senior student, like many of you here today. Little did I dream that some day I would be here on the speaker's stand, with the presidents of all the major accounting organizations in the United States.

Professor Miller and the other members of the accounting department here at Ohio State teach more than accounting—they teach us to recognize the truth, and to have the courage to stand behind our convictions through any and all adversity. They taught me that a practical approach to accounting was more important than knowing a debit from a credit. It was a lesson which, learned in my undergraduate days, has been a guide for me ever since. For that lesson, I say, "Thank you, from the bottom of my heart."

The topic of my paper is "Financial Administration in New Mexico." To better undertsand the problems, let me tell you something about the state.

New Mexico covers an area of 120,000 square miles, making it the fourth largest state in the union. It is approximately 300 miles from Texas on the east to Arizona on the west, and approximately 400 miles from Colorado on the north to Texas and Old Mexico on the south.

Its population of 690,000 makes it rank 39th in the nation. Its density of population is only 5.6 persons per square mile, as compared to that of Ohio which is 193.8. Here in Ohio you have more than ten times the population in approximately one-third the land area. You have over 200,000 more people in Cleveland alone than we have in the entire state of New Mexico.

There are some things in which our "Land of Enchantment" excels, however. Since we are on a high plateau, with the altitude varying from 2,800 to 13,000 feet, our climate is superb. The summer days are hot and dry, but the nights are cool. Although we have an occasional snow in the winter, the weather generally is mild. Ninety-six per cent of the state's total area is grazing land, and livestock production is the greatest source of revenue. We rank first in the nation in the production of potash, second in zinc, third in fluor spar, and fourth in copper.

Approximately 42 per cent of the land is federally owned, thereby seriously limiting our ad valorem tax potential. It was at White Sands, New Mexico, that the first atomic bomb was detonated. The atomic city of Los Alamos is hidden away in New Mexico's Jemez Mountains, 30 miles north of Sante Fe. Our state capital, Santa Fe, can best be described as a large mountain village of thirty thousand people. Because it is located seven thousand feet above sea level, no passenger train climbs to its heights, and the nearest railroad station is at Lamy, fifteen miles away.

Because of its hot, dry climate, it is known the world over as a haven for sufferers of respiratory disorders. Of the three candidates who ran for United States Senate in the recent Republican primary, two came to New Mexico to die from lung disorders some thirty or forty eyars ago, while the third one had come out there as a child, before he was old enough to become so afflicted. Out there, it seems that old politicians never die; they just go to Washington, instead.

My official title is comptroller-budget director. I was appointed to this office by our thirty-nine year old Governor in August, 1951. My duties consist of supervision of all accounting, post-auditing, and budgeting for all state departments and political subdivisions. Since there are 125 state departments, 10 educational institutions, 32 counties, 73 incorporated municipalities and villages, 80 municipal and independent school districts, and 32 county boards of education supervising about 600 school districts, this task is no small one.

Supervision of accounting includes the formulation of uniform systems, forms, and reports. Although a reporting system had been operating for many years before I took office last August, many improvements are needed before a clear picture of current operations can be had. Most of the accounting was designed to control expenditures in accordance with approved budgets, with little or no emphasis on the control of revenues. This was especially true on the county level, where the clerk would continue to issue warrants as long as he had a budget balance, or until the treasurer would inform him that the fund had no cash balance, because collections had not been up to expectations. The solution to this problem would be to have one general ledger for the county, with receipts being posted from the treasurer's journal and the disbursements being posted from the clerk's journal. This solution seems so simple that it is hard to understand why it has not been done long before this.

When the original comptroller's law was passed in 1923, there were not enough trained auditors available to enable the comptroller to build up a staff. For that reason, the post-auditing was "farmed out" to practicing public accountants who did the work on a contract basis, with the approval of the comptroller. This practice has been continued, for the most part, until the present administration. Now the law has been re-examined and reinterpreted to mean that the post-auditing should be done by the comptroller's staff, and not by outside auditing firms. This interpretation was further strengthened when the duties of the comptroller and the duties of the budget director were combined. It was felt that the best way to study a department from a budget director's standpoint was to audit that department. An outside auditor is primarily concerned with the legality and proper accounting of expenditures. The economic justification or administrative soundness of a particular expenditure is outside the scope of his audit, and therefore not made available to the budget director in the review of budget requests. Because of the wide range of state operations, the budget director could not be expected to analyze the budget requests comprehensively because he was too far away from the problem. As a result, I feel sure that many budgets in the past were approved by default rather than from a sound, economic standpoint.

As of the first of this year, the announced policy of the comptroller's office is to audit all state departments located in Santa Fe rather than have the work done by independent auditors. Since there is approximately $100,000 worth of auditing work performed annually at the capitol, it promises to be an interesting experiment in building up a staff to handle it.

The preparation of annual budgets for the state and its subdivisions except the counties, municipalities, and schools, is the direct responsibility of the comptroller-budget director's office. Budgets for the counties and municipalities are prepared under the supervision of the state tax commission, while the school budgets are prepared by the school budget auditor, who, although technically under my jurisdiction, maintains a large degree of independence due to the size and the special training required in that field. Once the budgets have been approved, however, the responsibility for control of expenditures within the budgetary limits rests with this office.

In an effort to relieve the comptroller-budget director, the 1951 legislature passed a law providing for a board of educational finance whose duty it was to handle the financial problems of the higher educational institutions. The expense of this board's operation is being borne by the institutions involved on a proportionate basis. The membership is made up of one representative from each of nine judicial districts. This in effect, gives each major institution at least one representative on the board. With that arrangement, it will be interesting to see if the lawmakers have eased the problem of having nine separate pressure-groups fighting for appropriations. There is a growing feeling that this new group could, if not properly controlled, become a super-lobby which would be worse than what we had before.

Students of accounting would say that to combine the functions of budget preparation with that of post-auditing violates a basic rule of good business management in that one person should not be in position to check the results of the financial plan he originally prepared. My only answer to that objection is that we are doing it, and that it works. The practical results obtained far outweigh the theoretical deficiencies of such a system.

I do not mean to belittle the theory of organization. However, the financial apparatus and operations of New Mexico have become extremely complex and confused. When the various operations have become straightened out and good procedures developed, then it will be time to think about separating auditing and control functions. But for the present, it would merely add another log to the flames of confusion.

In order to better cope with the problem of financial administration, a state board of finance was established in 1935. It is composed of the governor, the state auditor, and three additional members appointed by the governor, with the consent of the senate. Not more than two of the appointed members can belong to the same political party. The terms of office of the appointed members are for six years, with one term expiring every two years.

As executive officer of this board, the comptroller is required to advise and assist it in the performance of its duties.

The state board of finance has general supervision of the fiscal affairs of the state and of the safe keeping and depositing of all moneys and securities belonging to or in the custody of the state. It has authority to make such investigations as it deems necessary to enable it to perform the duties imposed on it by law, and to employ such experts, auditors, accountants, and attorneys as it may need.

The state board of finance is often referred to as the "Little Legislature" because of its power to revise appropriations after the legislature has closed its sixty-day session, which is held once every two years. This board can reduce expenditures from the general fund up to twenty-five per cent of the total appropriations in order to keep them within funds available. In this manner, the state has been able to keep a balanced budget, even though revenues might fall short of the estimates presented to the legislature at the time the appropriation bill was passed.

Another important power vested in the state comptroller is that of suspending county or municipal officials from office. There are two statutes which provide for such action. Both statutes provide that an official can be suspended for fiscal mismanagement in office, resulting in the violation of any statute relating to fiscal management or in the violation of any rules or regulations issued by the state comptroller. However, one statute further provides that willful failure to perform his official duties must be present, while the other requires the presence of fraudulent misappropriation or embezzlement, gross negligence, malfeasance, or nonfeasance in office. Another important difference between the two statutes is that one provides for a five-day notice prior to suspension while the other provides for immediate suspension and a subsequent hearing within five days. Under both statutes, the comptroller takes complete control of the office until either the suspension is lifted by him or the official is reinstated or permanently removed by court action before a district court jury.

The combination of the two statutes gives the comptroller considerable discretion in invoking a suspension, and leads to no end of confusion with the defense attorneys in fighting the comptroller's action.

In a recent case, a grand jury, called to investigate the affairs of the most populous county in the state, gave a report in which it recommended that the two Republican county commissioners of a three man board either resign, be suspended by the state comptroller, or be removed by court action. Immediately after the report was released, I made a personal examination and found enough irregularities to warrant a suspension. I then issued an ultimatum to these two commissioners that if they did not resign by ten o'clock the next Monday morning, I would suspend them. One commissioner gave me his resignation at the last minute, while the other one left the court house shortly before the appointed time, ostensibly to see his lawyer. When he had not returned by ten-thirty, I sent the suspension order to him by the sheriff's deputy.

By all the unwritten rules of the game, this commissioner should have resigned after that. Instead of playing according to the rules, however, he decided to fight my action through the court. He retained a former governor, who is considered one of the best trial lawyers in the state, while my counsel was the district attorney, a staunch Democrat.

My staff spent five weeks in the conduct of the examination. We investigated everything that might be irregular by personally contacting the vendors or by actual visual examination of the commodities purchased. It was much more than an audit, because the stakes were high.

During the course of the examination we stumbled across six vouchers which later proved to be fictitious. In a separate trial, an assistant to the commissioners was found guilty of fraud and sentenced to from two and one-half years to three and one-half years in the state penitentiary.

After four days and nights of testimony, most of which was directed toward disproving the defendant's theory that the whole case was based on a political conspiracy between the Republican state chairman and the Republican state comptroller . . . (both of whom are former Buckeyes), the jury returned a verdict of "guilty" and the commissioner was permanently removed from office.

A newspaper columnist recently reported that, although suspensions had been made by former comptrollers, this was the first time in thirty years that it was necessary to have a court trial over it.

On taking office last August, I had no idea that I would be confronted with such an overwhelming number of problems. It is almost a full-time job to answer the day-to-day queries, unless one delegates these matters to a subordinate. The main problem seems to be that of assigning priorities so that the most important ones would be corrected first. All of the problems cannot possibly be covered in a paper of this short length. However, the major ones can be touched upon.

Probably the most important problem is that of establishing a tight budgetary control system. In the past, the budget director's office has been understaffed; therefore, it has been impossible to make comprehensive studies of the budget requests submitted by the various departments. As a result, most budgets were based on the prior year's expenditures plus increases in the items which the departments thought would be the hardest for the budget director to argue about. This was especially true of revenue producing departments which operate on administrative funds based on a percentage of collections. The revenues in some of these departments have risen far above amounts ever dreamed of by the legislators when the laws were passed, making it almost impossible to spend as much money for administration as the law allows. With this slush fund available, the tendency is for these departments to load their budgets with items that could be used for any purpose the director saw fit, political or otherwise. A budget based on economic justification rather than on the amount of funds available should save the state untold thousands of dollars annually.

A personnel department is needed badly. As it now stands, each department handles its own personnel problems, with no standards as to qualifications or salary scales. A merit system is needed in which employees can feel secure as long as they do their work satisfactorily, regardless of the tides of political fortunes. Our universities are training too many young men and women in political science and related fields only to have them leave New Mexico for other areas where political patronage is not quite as evident. Steps to correct this situation were taken when we elected, at the last general election, the first Republican governor this state has had in two decades. No clean sweep of Democrats in appointive offices was made. Instead, many holdovers were retained because it was recognized that they were best suited for the job.

A department of administration is needed. All service functions such as accounting, purchasing, maintenance, inter-office delivery service, printing, etc., should be contralized for economical operation. This would give the governor more control over the executive department by having fewer key subordinates to whom responsibility could be delegated.

The entire executive branch of the state government needs to be reorganized so as to streamline its operation for maximum utility. We have too much duplication of effort and inefficiency because the lines of authority are not clear-cut and overlap in many cases. Our state constitution provides for eleven elected state officials. At the present time, the governor has little or no influence over nine of them because they belong to the opposite political party, and they have set their offices up as almost autonomous units because of their constitutional origin.

At the present time, we have a "Little Hoover Committee" which is making a study of the executive branch of the government. Its final report is due by June 30th of this year, and will contain many recommendations contained in this paper. It has released studies of various departments for the last several months. Wherever possible, recommendations which could be effected by administrative action have already been carried out.

Government has become big business. The cost of operating our little state of New Mexico has increased from five million, seven hundred thousand dollars at statehood in 1912 to over one hundred million dollars in 1952. Furthermore, the trend has been toward more and more centralization. While fifty-one per cent of the 1912 expenditures were made at county and local levels, only thirteen per cents of the 1952 total will be expended at such levels.

Between 1940 and 1950, the total non-school employees in the forty-eight states increased from 394,000 to 636,000, or sixty-one per cent. During that same period, our population increased only twelve per cent. This means that our demand for governmental services increased more than five times as fast as the population increased during that decade. If we are going to continue to ask the government to do more and more of the things that our grandparents did for themselves, it is imperative that we make sure that we are getting our money's worth.

Accounting controls such as improved budget systems and cost accounting systems are needed badly. In order to make these improvements, we need to make government careers attractive to our accounting students by assuring them tenure in office, by paying good salaries, and by removing the stigma sometimes attached to a so-called political job. We are moving in that direction in New Mexico. Although the comptroller's office has been in operation for almost three decades, this is the first administration in which a certified public accountant has been appointed to that position.

I firmly believe that accountants can do for the government what they have already done for private industry by providing the tools for accurate fiscal control of our biggest business.

In closing, I would like to add that when an accountant goes into government, he has no claim by reason of professional competence to take over the functions of the legislature or the governor. But when an accountant goes into government, he must promptly become something more than a bookkeeper. And he is subject to the slings and arrows of outrageous fortune, and the shouts and insults of the opposition—but it is worth it.

## FOURTH SESSION

FRIDAY, MAY 16, 1952—7:00 P. M.
*Neil House*

Presiding:

W. C. WEIDLER, *Dean, College of Commerce and Administration, The Ohio State University, Columbus*

Address: "The Nation's Balance Sheet"

J. WILLIAM HOPE, *President, American Institute of Accountants, J. William Hope Company, Bridgeport, Connecticut*

Presentation of distinguished accountants to the Accounting Hall of Fame

# THE NATION'S BALANCE SHEET

*By* J. William Hope
*President, American Institute of Accountants; J. William Hope Company, Bridgeport, Connecticut*

The subject selected for my discussion this evening is titled "The Nation's Balance Sheet."

There is, you will agree, plenty to engage the interest of an examining accountant who might assume to compile a financial statement of our nation's business at the present time, and much that will test his ingenuity in the digging for facts and the reporting of their influence on our lives—present and future.

Certainly not in the time available at this meeting can even a summary of all of the many elements of our nation's balance sheet be presented, let alone their amplification.

The very mention of some of the items that are accepted as having a place in such a report would be the signal for the beginning of a soporific harangue that could go on and on to exhaustion, finding no agreement and leaving only more uncertainty and confusion.

Why then do we introduce such a discordant subject into a pleasantly agreeable meeting like this? Why don't we ignore all these borthersome things and make our own lives more comfortable by leaving the business of government to those who have been elected to carry it on?

The answer to these questions is obvious. Because we have a great stake in this business of government; because our way of life is dependent upon its solvency; because our lives, our fortunes and our sacred honor have been pledged to its maintenance; but most of all because it guarantees us the freedoms we have learned to cherish as our birthright; we do not and will not sit by idly while some one person or group takes over and assumes to tell us what we can do or cannot do.

Government by the people can be very cumbersome at times and probably, on occasion, quite a nuisance to those who are called upon to administer it, but it is still better than any other this world has ever known, and it is our purpose to keep it that way.

Thus it is not cause for surprise to find us thinking about our nation's business and endeavoring to analyze its qualities.

Purposely, in this discussion, I will skip over the balance sheet accounts that portray budgets, appropriations, expenditures, taxes, deficits, controls, strikes, laws, politics, and lobbys, and get down to an item that is formidable, yet is seldom given the thoughtful analysis its presence in our balance sheet deserves—the national debt.

As in the case of a great many other problems which concern us these days, we are too often the victims of propagandists and in the quality of the information which comes to us in the press, over the air, and from the rostrum.

We are confused by the pleaders of special purpose causes to the point that we can never feel sure we know anything that is dependable about this subject.

It is my hope that I can bring some light, and possibly some comfort, by citing a few of the facts about our national debt and discussing their effect upon our way of life.

Like a mother-in-law in the house, or a skeleton in the family closet, our federal debt is a reality which we must accept as a significant factor in our present national economy.

It gets us nowhere to affirm that it is a mistake for the mother-in-law to live with the children; or that the Federal Government should not have a large debt; or to decry the reasons why we are in the present situation. The reality is with us, and it behooves us all to examine the facts thoroughly and to develop a sane attitude and policy concerning it.

We have not, until fairly recently in point of our existence as a government, had a national debt of such proportions as to be an impressive force in its effect upon our entire economy, and it is, therefore, not surprising that we have failed to develop a sound, unified philosophy concerning it, or to have eliminated a lot of confusing and conflicting theories about it.

The mere mention of the public debt will usually bring forth a welter of vague and unrelated expressions of theory and attitude.

There are those among us who would rather just "let it lay," or "hope that it will gradually go away."

There are others who feel that it is just "a paper debt," and like the vermiform appendix, it is an appendage that we have to have, but which has very little relation to the organic, economic health of the country. This group sometimes lightly and unthinkingly adds, "it's a debt that we owe to ourselves," so, if it gets troublesome, "let's just cancel it out and start over again." This cavalier attitude is responsible for the vague fears of many people that the Government bonds may be defaulted, and causes much anxiety in the absence of facts.

Many of our financial experts support the theory that the debt is of no great consequence to our economy, if it is kept within sage "Quarantine" limits. During the late thirties, some economists set the limit at $40,000,000,000. In 1939, President Roosevelt asked Lord Keynes, the British economist, to suggest what he thought was a safe quarantine limit. They agreed that $67,000,000,000 would be "about the top." Our national debt grew to four times that amount. We have also been told that three times the annual federal income or the equivalent of one year of the total national income would be safe limits. This group of our thinkers on the subject support a policy that would bring the debt to within arbitrary limits, and then deal with the question as an isolated problem in our economy.

Then there are those who, accepting the maxim that debt is always a bad thing either for an individual or a nation, support the policy of ridding ourselves of the entire obligation as rapidly and in as great an amount as possible, without regard to its intrinsic relationships with the total economy. These persons usually view the debt as a giant millstone that can strangle our economic growth and our standards of living or as an economic bomb, which, if it gets out of hand, will bring our whole system tumbling down about us.

At the opposite extreme, we find some of our old friends of deficit-spending, depression days, who saw in governmental spending a means of regulating our economy. They now see, in our present large federal debt, with its tremendous potentialities for the regulation of credit and the control of the volume of consumer purchasing power, a new instrument for the manipulation and regulation of the functions of our economic system. The present debt provides them with a contrivance of far greater range than the deficit-spending devices of the depression days.

Thus, the average person, faced with these many diverse attitudes, and bewildered by the complexity of factors that are intrinsically a part of the entire debt question, resigns himself to a point of view suggested by a recently popular song, "I Don't Want It, You Can Have It, It's Too Much For Me."

Our debt policy, however, is subject to political considerations and controls, making it imperative for the large body of our citizenry to have an understanding of the facts concerning this obligation and a sane attitude towards the tactics we follow in dealing with it.

With this idea in mind, I would like to have you examine with me, briefly a few of the questions most frequently asked by the average person:

Question 1. *Are we likely to default in our payments as they fall due, and will the holders of our securities lose their investment?*

The answer to this question is a simple, definite, and final, "No."

Let us take a good look at our creditors, and try to understand who they are and how difficult they might be in their demands for their pound of flesh.

A classification of our creditor position at the high point of our indebtedness on February 28, 1946, in comparison with that at the close of the year 1951 was as follows:

| *Grouping* | *Holdings in Billions of Dollars* | |
|---|---|---|
| | *Feb. 28, 1946* | *Dec. 31, 1951* |
| Banking System (Federal Reserve and Commercial Banks) | 115 | 85 |
| Mutual Savings Banks | 11 | 10 |
| Insurance Companies | 25 | 16 |
| Individuals | 64 | 65 |
| Other Corporations and Associations | 29 | 32 |
| State and Local Governments | 6 | 9 |
| U. S. Government Agencies and Trust Funds | 28 | 42 |
| | 278 | 259 |

Much of this reduction in the total of the debt during this period was not the result of government operating surplus, but was due to the reduction of the heavy war-time cash balances which had been secured from bond sales, to the lesser balances of normal operating requirements. The government could effect this reduction by forcing commercial banks to relinquish their holdings, but let us also remember that in this same manner government can pressure these banks to accept its offerings of new bonds that are not readily saleable in other markets.

It will be noted that the largest increase in holdings has been in the Government Agencies and Trust Funds Classification. The social security trust funds hold the greater portion of the debt listed under this heading. Together these government trust fund sources are reported to have an annual surplus for investment of approximately three billion dollars. This amount in itself would be a substantial reduction of the floating debt and this action is deflationary in nature, a most desirable result during this last five-year period.

We hear many complaints about the government using social security funds for its current operating expenses and that it will have no ready money to pay pensions on due date. The fact is that these surplus funds are invested in government bonds, which are accepted by our private trusts and business organizations as an A-1 asset. I wonder what these complainants would have the government do—speculate on equities in the market or bury the money in Fort Knox?

Individual and other business interests, you will note from the quoted figures, have not materially changed the total of their holdings. They appear to be satisfied to have this type of security, backed by the Government, available for their investment when they have surplus funds. There is no reason to expect that this group of bondholders will need their funds at any one time. But, if they should, because of a sudden depression in business or for other reasons, it would be in order in a well-managed economy to have the banks take over such holding, together with new issues to finance Government projects which should be planned and ready in order to free the supply of money and credit at such times.

This quick look at our present debtor position would make it appear that, instead of being worried about their investment, our creditors are more likely to be disappointed when we insist on paying them what we owe.

Thus, I am convinced that our government, so long as it remains democratic in nature, will not be embarrassed for payment of its obligations, nor should we creditors be disturbed about collecting.

All of this opinion on our credit position is based on operations up to the end of last year. Right now, however, I am worried.

The proposed budget for next year projects a cash deficit of fourteen billion dollars and the only way this deficit can be financed is by the sale of bonds. With the market as wary as it is at present of government operations, the only quick outlet for these new borrowings is the Federal Reserve System. The commercial banks will be called on to pick up their shares and they will do so in most cases by leaving the bonds on reserve where they can be readily converted to support an increased loaning capacity of more than five and one half times the total of their enhanced reserve balances.

Our bankers are better businessmen than to grant credit in these increased amounts, but that does not excuse our financial planners who expose us to such a possibility as having seventy billions of new money in the market under present conditions. This is certainly inflation-feeding at its worst. At the same time the government is releasing the restraints on installment credit-buying, thereby inviting more clamor for consumer goods and more requests for new inventory loans.

We hear a great deal about increasing taxes to dry up the present surplus of money in the market in order to stall inflation, but where would we find seventy billions in additional income taxes to halt this threatened influx of new money? Seventy billions is nearly double 1951 receipts from income and profits taxes.

Either my viewing of this situation, or something in Washington is cockeyed, but for the life of me I cannot see how two and two make anything other than four.

But I better not let myself get too far off the track of my subject. I find it difficult to be unpartisan when I get going on the dangers of deficit spending under existing conditions.

So, back to my topic of the national debt as it is today.

Question 2. *Will our heavy burden of debt necessarily impede and blight our economic growth and stability, resulting in lower standards of living?*

The answer is, "Not necessarily." It is dependent upon the wisdom of our policy for the handling of the debt.

My assertion that the debt will not necessarily impede our economic progress is not meant in any way to mitigate my conviction that debt is not good for any person or government. I do not favor or encourage the sort of spending that builds debt.

On the other hand, I know that the incurring of debt is sometimes mandatory, and is not necessarily a bar to the continued enjoyment of the good things of life, if carefully managed.

In the case of the Government, it is generally agreed that our war debt was the cost of a necessary cause and, even in the face of present-day uncertainties, was a good investment.

For present purposes, however, my only contention is that, *having the debt,* it can be used for valid purposes, and in being so used, its shadow can be eliminated as a threatening blight on our economic progress.

If you will think back to my analysis of the several classes of debt-holding groups, you will recall that about half of it is held by individuals directly, or for their protection by savings banks, insurance companies, corporations, and associations. It is good that this is so, for these government bonds afford the safest sort of an investment for people who do not wish to, or should not, speculate with their surplus funds. And, as I have pointed out, there is as certain an assurance of the availability of the proceeds in cash when it is needed as there could be in any other place of safe keeping. On this point, I am not going to get into the argument about the reduced purchasing power of the due-date dollar. There can be good reasoning on both sides of that question.

Our participation in the war was supposed to have been for the purpose of protecting the property of our people. In its course, they had unusually good incomes, permitting them to make investments in government bonds which will pay them an annual increment of interest, and finally the principal, for their use in times and at periods when they might, in the ordinary course of affairs, be without funds sufficient for their needs. These additional resources will permit them to be customers in the market places, business will be better because they have money to spend, and the government's tax receipts will be increased accordingly.

In brief, the debt, if wisely handled, can provide sound investment opportunity; serve to spread purchasing power over periods of economic fluctuation; absorb surplus inflationary capital; have an effect on the volume of currency; tend to stabilize credit capital; and, generally, be useful in maintaining our standard of living.

Question 3. *Is tax reduction inconsistent with a sound debt policy?*

I am strongly on the side of tax reduction in this argument, for I believe that we would stifle business, as well as the initiative that made this country great, by continuing to tax the profits of service and productivity at the high rates which now prevail. I could go on at great length on the subject of confidence-destroying taxes, but here again I might be accused of being partisan and I am anxious to keep my political thinking out of this discussion.

In periods of inflation, as I have previously noted in my curt remarks on deficit spending, we find the economic doctors, who, like the blood letters of old, insist that the only cure is to draw off the excess of consumer buying power by levying higher taxes. But high taxes apply not only to the consumer who is bidding up the market, but in equal degree to the source of production capital, with the result that, in attempting to relieve the pain in the neck, the treatment dries up the sinews of the whole productive system.

I think tax reduction will bring debt reduction, while debt reduction preference will fail because there will be, in such case, no surplus of tax receipts.

Our debt financing procedures produced a plentiful supply of money, and business expanded accordingly. High tax receipts followed as a result. Debt payment, unless it is in small, easily absorbed, and carefully managed amounts, will have the opposite effect. There is no question but that the payment of a large part of the debt at one time would cause a serious depression.

Many proponents of debt reduction point to the six billion dollars of interest in the annual budget as an item that must be reduced promptly if we are to continue to balance the budget. I agree that this expense is formidable especially if it is classed with some of the other less productive expenditures of the government. Like the debt, we have it and must deal with it. And because we must, I choose to look at it as a payment of income to the public, which in part is immediately repaid in tax on it as income, and the balance of which goes into the channels of business where it produces more taxable transactions. Again, I insist, I do not like interest any more than I like debt. But I am trying to be practical in dealing with this problem.

Thus, I believe that lower taxes will remove some of the weaknesses of our present business operations by supplying the urge to more carefully guard against unnecessary costs and that there will be a consequent encouragement to greater production thereby providing, by the healthiest method, a most effective antidote for inflation.

In closing, I would like to summarize a few of the suggestions I have made for an approach to the development of a sound federal debt policy.

1. *We must accept the reality of the debt.*

The debt is with us, and it is important for us to think through carefully the wisest ways of living with it.

2. *We should recognize clearly its intrinsic relationship and influences throughout our entire economy.*

The federal debt is not an isolated phenomenon in our economy. Our attention should be directed to it as a definite parcel of our total economic policy and planning.

3. *We must develop a fixed and incisive debt-management policy.*

It should be the subject of continuous study by an advisory board of our best economists and fiscal experts, and free from self-serving pressure groups and partisan politics.

4. *We should determine its course in terms of its effects upon a fully productive, stable economy.*

Not because I like it, but because we have it, I would suggest that we can use the debt as a tool to serve our present purposes, while it is working its own way out of our economic picture.

5. *We should develop an intensive program of public education concerning our debt policy.*

Full public acquaintance with the facts concerning our public debt, its causes and its uses, will free us from debt maneuvers dictated by political expediency and from ungrounded fears and anxieties, thus enabling us more intelligently to deal with the problem.

If I have contributed to this end in any small way today, my purpose will have been well served.

## FIFTH SESSION

SATURDAY, MAY 17, 1952—10:00 A. M.
*The Ohio Student Union, West Ballroom*

Presiding:

RAYMOND E. GLOS, *President, The American Association of Collegiate Schools of Business; Dean, School of Business Administration, Miami University, Oxford, Ohio*

Address: "Budgeting Problems During a Period of Inflation"

CHARLES Z. MEYER, *President, Controllers Institute of America; Vice President and Comptroller, First National Bank of Chicago, Chicago*

Address: "Tax Planning in Today's Economy"

MICHAEL D. BACHRACH, *Bachrach, Sanderbeck & Company, Pittsburgh*

# BUDGETING PROBLEMS IN A PERIOD OF INFLATION

*By* Charles Z. Meyer
*Vice President and Comptroller, The First National Bank of Chicago, President, Controllers Institute of America*

American business is waging a continuous battle against inflation, our country's greatest enemy. The declining value of the dollar has confronted management with many budget problems, one of which is the difficulty of keeping enough cash on hand to meet increasing requirements. Inventories cost more to accumulate and maintain. Another important problem is that of replacing worn or obsolete equipment at prices which were undreamed of when depreciation reserves were set up. Taxes also enter the picture, not only because their amount is staggering, but also because their payment has been accelerated under the Mills Plan. This year, for example, corporations must have 70 per cent of their total federal tax paid to the government by June 30. All present budget problems.

It is easy to shrug off such problems by pointing to government statistics. Most of us have seen the recent study of corporate working capital estimates issued by the Securities and Exchange Commission, which indicates that working capital is at an all-time high. That sounds good until we look behind the figures and see that, for the first time since 1944, current assets fail to equal an amount double current liabilities, a hallowed and time-honored test of a well-managed business. We also find from the same survey that quick assets (cash, government bonds, and receivables) only covered current liabilities 1.23 times, the lowest ratio since 1939.

During the past year, the current ratio dropped 12 per cent; the quick ratio 15 per cent, and the ratio of cash and governments to current liabilities went down a whole 20 per cent.

So, on the one hand, business, like most private individuals, has more dollars on hand than ever before. But on the other hand, also like Mr. and Mrs. John Q. Public, management worries because even this pile of cash is smaller in proportion to needs than it has been since the depression.

Every citizen who is faced with such conditions reacts pretty much the same way: first, he puts the brakes on needless and marginal expenditures; second, he sets up some kind of a budget or schedule to make sure that he has enough cash on hand when the rent bill comes due or the installment collector comes around. In essence, that is what management is doing today, doing on a larger scale and with greater determination and devotion than ever before. In most companies of large or middle size this duty falls on the controller. He is the man in every substantial business unit who watchdogs the treasury and keeps an eye on its financial health and condition.

Cost reduction and cost control come directly within his bailiwick. The facts which he collects, records, interprets, and distributes make it possible to achieve economies and cut waste. His success in those directions helps to keep down prices on things the company sells. The figures on the retail price tag, as well as on the armaments the government is buying, have a direct relation to the figures on the accounting books wherever the goods are made.

## Technological Improvements

One of the most interesting trends in business today is the development and use of machinery and other devices to speed up the collection and employment of facts and figures. Electronics have been put to work: one large company has found that financial reports which formerly consumed fifty man-days in manual preparation are now produced in eight hours through the use of the so-called "brain" or electric programmed calculator. Future electronic equipment, this firm believes, may produce them in one hour. Such equipment promises to eliminate the drudgery and pencil-pushing of accounting, which means more time for tomorrow's controllers to spend on interpreting facts and solving problems.

Less dramatic are the scores of other time savers, such as tabulating accounting, photo recording and other processes and machines which help to give top management the facts it needs in time to use them effectively. In other words, accounting and controllership are working more and more *in the present tense*, and less and less in the purely historical sense. This means quicker and more accurate follow-up on budgets: it also means that instead of being primarily the custodian of "cold statistical facts," the controller and his staff are in a day-to-day position of detecting deviations. The transition from making the budget to *enforcing* it has involved the controller's department in a human relations situation for which some are unprepared. In fact, the Controllership Foundation, which is the research arm of our Institute, has just completed a study of this problem. Entitled "The Impact of Budgets on People," this survey confirmed the need for training budget people in "selling" the budget figures to supervisors and the rank-and-file.

## Making Budgets do a Better Job

The major findings in this survey confirmed what progressive controllers had suspected for a long time, namely that (1) budgets tend to defeat their own purpose unless the human relations problems aroused by their use are solved, and (2) the conflicting reactions of budget personnel and factory supervisors can be ironed out and replaced by cooperation and understanding on either side.

To define a budget as a means of controlling cost tells only part of the story. Actually, it aims toward that objective by controlling *people.* The figures in the budget become a mould for human action: they constitute a pattern which personnel are enjoined to follow. Failure to "make the budget" implies a fall from grace, inviting disapproval, disciplinary action or worse. Yet important differences exist between factory personnel and the "figure man" whose job it is to set up and police the budget. Many human relations problems stem from this conflict in attitudes. In addition to not "speaking each other's language," the two sides disagree on the value and purpose of the budget.

Budget people, for example, regard the document as a means of improving performance, a way to uncover inconsistencies, errors and weaknesses and report them to top management for correction. They feel that budgets provide motivation by giving production personnel a goal to shoot at. The factory people, on the other hand, complain that budgets were being used as pressure devices, and that finance people care only about end results and overlook the problems which make those results hard to achieve. They also resent the fact that the budget man's "success" in discovering weaknesses in the factory actually places the foreman in a failure situation.

Two basic ways to overcome the problem were brought out by this research. One is to obtain true participation from the factory supervisors in making up the budget, as opposed to confronting the foremen with a budget that is already set. The researchers also recommend human relations training for the budget people, to help them win acceptance and cooperation from the production personnel—in other words, to help them "sell" cost records and budgetary control. Financial people at all levels could profit from such training.

### Business Forecasting and Tax Planning

Business forecasting and tax planning are two other important spheres where the controller's "know-how" helps to combat inflation. His surveys and market studies help to keep the company's capital expenditures in line with actual needs, while his insight into the probable tax consequences of business decisions helps to prevent unwise steps. For example, an unjustified increase in inventories may tie up so much of the company's funds that money to pay income and excess profits taxes might have to be borrowed, thus contributing to inflation.

We are only beginning to realize how the impact of high taxes is changing the nature of business problems. Evaluations which exclude consideration of tax issues not only tend to be unrealistic and incomplete, but may also involve the company in unforeseen tax consequences. Many of these issues have traditionally been settled on their merits; the timing of sales; the expansion or contraction of inventory; the negotiation of wage contracts; a change in policy governing credit, trade-ins or discounts; investment decisions; the timing and method of purchasing equipment and other capital assets; budgeting for research and development; and the like. Another range of problems involves accounting decisions, such as shifting from FIFO to LIFO; cash versus accrual accounting; selecting or changing the accounting period; allocations of cost and purchase price, etc.

This area was closely examined for the Controllership Foundation by a research team directed by William J. Vatter, professor of accounting at the University of Chicago. Based on an analysis of 400 actual case experiences, the report shows how management decisions of various types have resulted in minimizing or deferring the impact of taxation.

"Management Planning for Taxes," as this groundbreaking report is named, divides decision-making into three categories, the first of which consists of cases in which the tax consequences determine the *method of accounting to be used*, or the forms and the procedures to be followed.

The second category defined in the report involves cases in which the *manner of carrying out or implementing* a management decision is determined by tax advantage, as in the cited instance of a company which reduced the effective cost of pensions by funding a substantial portion of its plan.

Cases in which managerial decisions are affected by the tax factor, or made with recognition of it, are placed in a third category in this study. Typical of this group is one case in which a firm timed its 1950 discounts to apply against 1951 purchases, thereby transferring some revenue of 1951 to 1950, with a corresponding tax economy. Again, a company using the LIFO method of inventory accounting used a tax advantage to buy additional material and save taxes, which brought the net cost of the purchase under the market quotations.

## Making Employees Tax Conscious

This is only one part of the tax problem. Equally important, perhaps even more vital in terms of future cash position, is to influence everyone in the company who makes decisions to make them in the light of *probable* *tax consequences.* In other words, a way must be found in each company whereby tax information can be communicated to the people who actually make the decisions before the decisions are made.

The basic problem is how to insure that the highly specialized tax know-how is spread from the few experts who normally possess it to the entire decision-making organization of the company.

Much of the communication within a business about taxes is necessarily informal. One firm, for example, has a "junior board of directors" which meets with the controller and other top executives and tax administration is brought up at regular intervals. Another company holds meetings of supervisors in various divisions. Tax angles are explained along with the reasons for procedures, company policies and other decisions involving taxes.

Formal procedures also pay off handsomely in this field. In one case the company president requires a report in advance on all expenditures exceeding $250, and the tax executive is asked for comments on those which involve tax considerations. Another company starts each week with a meeting of the top executives. The past week's operations are reviewed and plans for the future discussed. At every meeting the controller has a chance to point out the tax implications in any action proposed. In another company all important problems are discussed by an executive committee. The controller and the tax man go over the agenda in advance to bring out any tax issues involved.

In smaller companies which lack trained men, outside attorneys or tax accountants are often called upon for advice. A number of instances were found in which the tax advisors serve informally as members of a "management committee," and function as the controller or tax man would in a management meeting of a large company. In this way a small business is able to achieve at least part of the advantages of tax advice at a cost it can afford.

### Beating the "Pay It Out of Taxes" Fallacy

One of the difficulties every controller has to overcome is the laxity which inevitably follows on the "pay it out of taxes" fallacy. Regardless of the tax brackets in which a company operates, and even though the imposition of high rates means a corresponding reduction in the portion of expenditures directly borne by the company, the fact remains that unwise or uneconomic spending is still extravagant and undesirable. The habits engendered in the high-cost, high-tax inflation period are bound to leave their traces when the shoe is on the other foot.

The same is true of "cheap dollars." Those dollars in your company's bank account may be worth only 53 cents in terms of present purchasing power, but they are dollars nevertheless. In fact, the less they are worth in terms of 1939 standards, the more of them are needed to pay 1952 bills and wages.

No matter how one heads in this realm of finance and accounting, you always get back to inflation. That is one more way of saying that inflation is our Number One Foe, and that we cannot triumph over national and international problems until we have it licked.

Budgets are primarily top management control instruments. Budgets present a goal, a challenge to those who produce, but unfortunately budgets do not show the *reasons* they were not achieved.

During these inflationary times, when government is spending $2,690 each second of every hour of the day and collecting $1,700, when, for example, users of telephone service pay an average of $17 in excise taxes per telephone while a juke box is taxed only $10, we cannot avoid drastic impacts on budgets—and that goes for our National Budget also.

I know I have digressed, but that is in keeping with the times. However, I am proud to close with the statement that controllers and their professional organization—the Controllers Institute—are fighting without let-up, and have joined for the duration.

We will not relax, we cannot relax, until this threat has been removed from our country and our economy.

# TAX PLANNING IN TODAY'S ECONOMY

*By* Michael D. Bachrach
*Bachrach, Sanderbeck and Company, Pittsburgh, Pennsylvania*

The Revenue Act of 1951 imposed the highest tax rates in our history, and with the continually increasing tax rates comes a greater and greater need for tax knowledge in business affairs.

A few days ago I received a pamphlet from an insurance underwriter which dramatically illustrated the effect of increased tax rates over the past twenty-five years. Even though I am a C.P.A., I get a little dizzy with the figures I found in that pamphlet. However, here are a few that are simple and easy to follow. They illustrate the point.

Let us assume a man has a net taxable income of $10,000. Today on an income of $10,000, the tax is $1,622. As a matter of fact, this must be the 1949 rates because the 1952 rates are appreciably higher. Living costs are assumed to be $7,500. So, deducting the taxes of $1,622 and the living cost of $7,500, there is left for savings $878, which, if invested at 2½ per cent, in 30 years would yield $39,510. In other words, a man working at a salary of $10,000, living normally, could hope in 30 years to build up an estate of roughly $40,000. If he retired at the end of that 30 year period, and was able to invest his money safely at 2 per cent, he would have about $800 a year.

Compare that with a situation of a man who earned $10,000, 25 years ago. On his $10,000 income he paid a tax of $204. The living cost comparable with the $7,500 of today was then $4,500. He had left to save $5,296, which, if invested at 4 per cent, in 30 years would amount to about $297,000, which, if invested at 2 per cent, would yield him $5,940 a year. Thus our friend of 25 years ago could have hoped upon retirement to have accumulated a sufficient sum to give him a reasonable income for the rest of his life. Today that is not likely to take place.

There was a time when we were concerned with the most advantageous manner of conducting our business transactions, but today, with the increasing complexity of the tax laws, we are concerned with avoiding unexpected tax liabilities merely because we carried on a business transaction in what we considered a normal manner and found we had become liable to unexpected tax burdens.

It has been standard practice for many years for a businessman conducting his own individual business to incorporate his business if he wished to either because of the limited corporate liability or because his earnings had reached a point that he would pay less in aggregate taxes if he owned the building in which the business was located, he may wish to transfer the assets of the business to the new corporation, but to keep the buildings in his own name for a year or two, so that after the corporation was underway, he could sell the building to his corporation and have a capital gain.

The corporation, in turn, having purchased the building from him, could start depreciating all over again, and there was a saving in taxes to the corporation.

That has been stopped, and I just point that out because as sure as you know it, some sole proprietor of a business, having heard sometime ago that the thing to do was to sell the assets of the business first and the building afterwards, will do it again. However, he will discover the Revenue Act of 1951 now contains a provision which says the sale of depreciable property to a controlled corporation results in ordinary income, and is not capital gain.

It has been customary for many corporations to decide some day that they would start a subsidiary company to engage in some additional business activity, or a subsidiary would be formed to take over a going business. It was not unusual to capitalize the subsidiary for a certain amount.

To illustrate, let us say corporation A decides to form another corporation, which we will call corporation B. Corporation A puts $100,000 in corporation B to start it off in business. That practice is not always advisable under present conditions. You may find the parents company has divested itself of part of its excess profits credit in allocating parts of its own investment to a subsidiary company.

Corporation A will now pay more excess profits taxes than otherwise, and there may be no corresponding benefit to corporation B, the subsidiary.

Allow me to describe the phrase "excess profits credit" because there may be some in this room who are not familiar with it. It is one of the most potent phrases in income tax terms today. Today among many business corporations of the United States, there is much activity upon the part of the comptrollers and their tax accountants or tax advisers.

There is the greatest scramble to build up the highest possible excess profits credit, because the higher a corporation's excess profits credit is, the less excess profits taxes it pays. The ingenuity of the minds of men has never been put to such great tests as the efforts that are being expended today in going back to the beginnings of their corporations' history, and trying to develop as many additions to the excess profits credit as possible.

A corporation is given a choice. Before you pay excess profits tax, you must first determine what portion of your earnings is normal and which portion is excessive. You have a choice of two methods. You can use the average income for certain previous years and consider that to be normal, or you may take a certain percentage of your capital investment and consider that normal. You may choose whichever one gives you the best results, and you may change from one year to the next. Whichever you take, if you are foolish enough to point to the books and say, here are the earnings for the best years, you will not be doing yourself justice. Anyone with a knowledge of the complexities of the tax laws and with the experience with the excess profits tax laws of World War I and World War II can come up with some amazing ideas of how the excess profits credits may be increased.

It is true that you can come up with the ideas, but that does not say the government will agree with them, but you have a fighting chance.

Having mentioned the excess profits tax, which is described as the most complicated piece of legislation ever put in the statute books, I would like, for the benefit of those who have not read the statute itself, to read a typical paragraph as an example.

The law is attempting to say here that if a corporation has a loss instead of a profit for a certain year, that loss may be carried back or forward to some other year.

This is Section 433-a-1-J. It has subdivision a, b, c, etc. Subdivision a has 1, 2, etc. Subdivision a-1 has A, B, C, etc. This is subdivision a-1-J.

"Net Operating Loss Deduction Adjustment."

"The net operating loss deduction shall be adjusted as follows:

"Subsection (1). In computing the net operating loss for any taxable year under section 122 (a), and the net income for any taxable year under Section 122 (b), the deduction for interest shall be reduced by the amount of any reduction under subparagraph (N) or (O), whichever is applicable, upon the basis of excess profits credit for such taxable year; and

"Subsection (11). In lieu of the reduction provided in section 122 (c), such reduction shall be in the amount by which the excess profits net income computed with the exceptions and limitations specified in section 122 (d) (1), (2), (3) and (4), and computed without regard to Subparagraph (C), without regard to any credit for dividends received, and without regard to any credit for interest received provided in section 26 (a), exceeds the excess profits net income (computed without the net operating loss deduction.)"

Do you know what this quotation means? The essence of the first part is this. In carrying over this net operating loss from one year to the next, if the deductions for that year include any interest paid, the amount of the interest deduction must be adjusted downward. This adjustment is in proportion to the part of borrowed capital which has been added to the invested capital.

The second half of what I read says this. If, included in the income of the corporation for that taxable year, are any dividends from any other corporations, the net operating loss carry-over must be reduced by 100 per cent, rather than 85 per cent, of those dividends, in order to arrive at the amount of the net operating loss deduction for purposes of the excess profits tax.

From time to time a corporation has occasion to buy back some of its own stock. We call that treasury stock. It is not unusual for a corporation to purchase back some of the stock held by an employee who is leaving the company.

Ordinarily there is nothing wrong with that transaction. Frequently the amount paid for those shares is more than the original cost, because the company now has a surplus. However, I want to suggest to any of you who are connected with corporations, the minute somebody says we are going to buy back some shares of stock, investigate carefully because the way it is done may have an important bearing on your excess profits credit.

It depends on whether you are computing your income on the average income method, or capital method. Do not buy back a stockholder's share in your corporation without checking first to see what effect it will have on excess profits tax liability.

Occasionally a corporation decides it needs more money. There are two ways that it can obtain more money. One way is by borrowing it from a bank. I will explain later that that is an excellent idea, because the situation has now reached a point where you save taxes by borrowing money.

Another way is to go to the capital market and float a new stock issue. There are two ways of floating a new stock issue. You call in the broker and tell him you would like to issue a million dollars worth of stock. The broker pays you $900,000, sells the stock for any price he can get up to the million dollars, and keeps the difference. That is no longer a good way to do it.

The proper way is to say to the broker, we are issuing a million dollars worth of stock, and upon that amount you will receive a commission of 10 per cent, or $100,000.

If you do it the first way, your invested capital is increased $900,000. If you do it the second way, you issue it for a million dollars, and pay him a commission, your invested capital is increased by a million dollars. That is worth something, that difference.

Not long ago there came to our office a gentleman who stated that he was connected with a corporation engaged in the small loan business, family loans. He was on very friendly terms with other small loan companies in Pittsburgh and its suburbs, and they were beginning to feel the competition of the large national finance companies.

He said, "We have decided, in order to meet the competition of these large national finance companies, to merge eight or ten of the small, independent loan companies in the Pittsburgh area."

Normally that is exactly what they would do, and had he gone to his attorney, unless the attorney was tax-wise, the attorney would have merged the eight or ten small loan companies into one large company, having offices in the respective communities. We told him that he should not do it that way. By keeping the separate corporate identity of each of these companies they have the kind of a tax saving that many larger groups would like to have. Many larger corporations, operating a number of units, wish they had separately licensed each unit. To do that today may invite resistance, not only invite it, it will immediately meet with resistance on the part of the Internal Revenue office, and may invite litigation.

There have been cases where business concerns broke up into several units, and one even succeeded in having their actions upheld. But they had to show good business reasons why it was done.

The Commissioner of Internal Revenue now has authority, if you break up business into several units, to toss them into one pot for income purposes, and assess a tax on the entire amount.

Here was a group of business concerns who have the ideal set up, talking about merging into one single corporation. We suggested instead that they form a holding company which would own the stock of the separate subsidiary corporations. Each would be independent, and would file its own tax returns and have its own tax credits. Obviously, unless those members operated at a loss, they would each file separate returns.

I would like to tell you very briefly a story of what happened to one of our clients whose name hit the newspapers and all the tax publications, and the case almost got into the United States Supreme Court. The name of the company is the Edwin L. Weigand Company, manufacturers of electrical appliances in Pittsburgh.

In June 1940 that corporation had outstanding 4,000 shares of class A stock, $100 par common stock, and 24,000 shares of class B no-par common stock. They decided to declare a stock dividend. We told them it was O.K. It would be non-taxable stock dividend, so upon our advice they issued to the shareholders some stock dividends. The shareholders who owned 4,000 shares of class A received 2,000 shares of additional class A; the 24,000 shares of class B received 12,000 more shares. The ratios were the same. There was no change in the qualifications of the stock dividend rights.

There was, however, one wrinkle upon which we almost stumbled. The class A shares were entitled to a dividend before the class B shares got any. The class A shares were entitled to a dividend of $6 per year thereafter. The class B shares were entitled to $2, and after that, both classes shared alike in subsequent dividends. Therefore, as long as there were 4,000 shares of class A outstanding, it took $24,000 of the profits to take care of class A before class B had anything.

Now, there were 6,000 shares of class A out. It took the first $36,000 of profits before B got anything. The corporation was earning $400,000 or $500,000 a year, so there was no problem. The stock dividend was issued, and everybody was happy.

A revenue agent examined the corporation return and O.K.'d the stock dividend. This concern closed the books on June 30, and it happens that on fiscal year June 30, 1940 there was a vestige of undistributed profits tax where the dividends paid were treated as a credit for undistributed profits tax purposes. We did not claim that dividend to be a reduction of the earnings to which the tax applied. We treated it as a nontaxable dividend. That was approved by the government.

The tax returns of the individual shareholders for 1940 were filed before March 15, 1941. They were subsequently examined and approved.

The government has three years from the time a return is filed, as to that return, and those three years expired on March 15, 1944, but there is a section of the Internal Revenue Code that says if there is more than a 25 per cent understatement, then the limitation is five years, not three.

Acting under that section, on March 10, 1946, five days before the end of the five years, each shareholder was assessed a tax on this particular stock dividend. At the last minute the government decided to tax what had previously been considered a tax free dividend.

We had to get busy. We could not pay it. It went to the United States Tax Court. There were two trials, one to determine whether the dividend was taxable, and the second to determine the value of the stock, if it was taxable. The United States Tax Court held that the dividend was taxable.

We then filed in the Circuit Court of Appeals. One stockholder lived in Chicago, the others lived in Pittsburgh. We filed in two Circuits. The hearing in the Third Circuit took place first. The Seventh Circuit decision came out ahead. The Seventh Circuit reversed the Tax Court, and said the dividend was non-taxable. Shortly after that, the Third Circuit came out and said, "We agree with the Seventh Circuit, but hold the dividend is taxable." That gave us exactly what we wanted, a conflict between the two circuits.

The lawyers were preparing the appeal to the United States Supreme Court when the Third Circuit called for a re-hearing. Another hearing was held before the Third Circuit. They asked us to argue the case all over again, which was done with a little better presentation. The Third Circuit ignored its previous decision and said, "We now have decided that the stock dividend is non-taxable," thereby clearing the whole issue.

Of course, since there was no conflict between the Circuits, we presume that the government will let it go. In fact, the time has passed, depending on whether the date runs from the time of the original decision, or the date of the re-hearing.

What have we learned as a result? Item one, we have a client who is in the manufacturing business, who started seven years ago, with a capital of $75,000. He now has that same capital, but with the accumulated surplus of $2,800,000. He is very proud of his financial statement. He likes it to show capital stock and surplus. That is his way of telling the world how successful he has been in the manufacturing business, but it is not the right way to tell it any more.

The Revenue agents no sooner get a good look at the surplus as compared with the capital than they start asking questions, which up to this time, we have successfully answered. The President of this corporation does the answering, and he is good at that. However, he has finally become reconciled to changing the situation. We are having a conference with him, discussing how to recapitalize the business. He can increase his capitalization and declare a stock dividend. That would be the simplest way. But we are afraid of declaring stock dividends.

The law says a dividend on common stock is exempt from taxation. That was supposed to have been settled in 1920 or 1921. Yet I say to you, before anyone declares any kind of stock dividend, it would be well to get a ruling first.

In the course of a discussion about this recapitalization, the thought came up, why not have common stock and preferred stock? So we would keep his common stock as evidence of ownership in the company, and have his preferred stock to hand out as gifts to the members of the family and have income and estate tax. There was a time, if there was only common stock outstanding, that you could issue a dividend of preferred to common that would be O.K. That is not too sure any more.

We are debating how that should be done, and whether it should be done, but I am only illustrating that in the simple matter of capitalizing part of the surplus, if you do it right, you will consider not only how it should be capitalized, but whether it is well to have more than one class of stock, and above all, the important thing is that we get a ruling first.

There is another angle here. He has an idea that it might be well if he would spin off. Let me give you an illustration of where it is being done. A corporation has an automobile dealership, a very beautiful building, and a very good business. It is one corporation. The owner would like to get the building to himself. He would like to have the building, and the corporation can carry on with the remaining assets of the business, but if they should declare a dividend to him and give it to him in the form of the building, he would have a substantial income tax to pay.

There is another way which Congress gave us. We are going to form another corporation. Instead of the General Motor Company, they will be the General Realty Company. Let us say he now owns the General Motor Company. The first thing we will do is to form another corporation called the General Realty Company, with authority to issue $300,000 worth of common stock. You can authorize as much stock as you please. You pay a small fee. We form a corporation with the authority to issue $300,000 of stock.

The General Realty Company will then purchase that building from the General Motor Company, and give the General Motor Company the $300,000 of its stock in payment for that building.

The General Motor Company formerly had an asset on its books called building, $300,000. It now has stock in a subsidiary company. The books are still in balance. We take this stock of the General Realty Company which we, the mother company, now own, and distribute it to our own shareholders. Mr. X, the client, is the principal shareholder. He has 98 per cent of the stock, so he gets 98 per cent of the stock of the General Realty Company. He does not surrender any stock in the General Motor Company because he is now permitted to keep his old stock and receive as a tax free distribution the new stock because of the spin off provision of the Code.

Of course, there are some hitches in this. The Code says that will be considered a tax free transaction if the new corporation is engaged in a trade or business. We will claim that owning and operating a business building is a trade or business. We have a number of precedents for that argument. The implication is that Mr. X, when he received the General Realty Stock, should hold it lest it appear as if he were trying to get additional shares to get cash out of the company. We have no intention of selling the realty stock, but we will a few years from now unless they tighten this up.

Mr. X, who now owns practically all the stock of the realty company, will liquidate the realty company and take the building to himself. At that point, however, he will pay a tax. At that point he will have a capital gain because the building will be worth a lot more than the cost to him of this stock that he received in this reorganization, and what is the cost to him of that stock? It is a proportionate part of the original cost to him of the stock in the old company.

I will take a few minutes to point out some of the tax saving opportunities. This is a sort of added attraction to give you some ideas of how to save some taxes because of what has been included in the recent tax bill.

It is now permissible to bring your wife or minor children into your partnership. You give them an interest. They pick up a proportional earnings, pay their own tax on earnings, and when a client asks me about this tax saving feature, I generally try to discourage him. I say it is true that you will save income tax and save estate tax by transferring part of your ownership in the business to your minor children. However, the transfer of interest must be made with all due legal formality. The interest in the business will then belong to them and may be the cause of a family disagreement.

At any rate, you may now include minor children directly or through a trust in a family partnership. It is permissible at long last. Family squabbles have been eliminated by law.

Here is another gimmick if you want to save taxes. It used to be if a farmer with an orchard would sell his farm complete with all the fruit on the trees, the law was that the gain on the sale of the land was a capital gain, and the revenue from the sale of the growing crops was ordinary income. That has been changed. When you sell a farm with the growing crops or the growing fruit, the entire procedure now is treated as a capital gain.

Do you know how to make money? Buy a farm, grow a lot of crops, but before you harvest them, sell the whole works at a big profit. That is a capital gain. Then go around and buy another farm. Do the same thing. Look at all the money you will make.

The law provides now that you may give your employees' families tax free income upon their death. This is interesting and important, and many concerns are taking advantage of this clear, permissive tax saving. (Any corporation or any employer who will enter a contract with an employee, and some say that even a resolution in the minutes is a sufficient contract, which says that upon the employee's death, there will be paid to the employee's beneficiary up to $5,000, that amouet may be deducted by the employer, and is free of income tax to the beneficiary.) I know there are many employers who have faithful employees of long years of service who are happy to know they can make such provision whereby, upon the death of the employee, his family may receive $5,000 free of income tax.

I am going to take two more items. There is a device which is engaging a great deal of attention called restricted stock option. The boss officer of a corporation calls in one of his employees and says, "I will give you an option to buy 1,000 shares of stock in this company." The employee says, "I don't have that much money." The boss says, "I know you don't, but you don't need any money. I will give you an option for five years. Our stock is now worth $40 a share. I will give you an option for five years to buy at $35 a share. I feel that within that five year period this stock is going up. I feel that your valuable services will make this stock go up. When the stock gets to $60, then you will pick up the option at $35, and look at all the money wou will make." That is what can be done.

The employee gets an option for 1,000 shares of stock at $35. He will wait for the period of the option. At the end of the five year period he throws the sheet of paper away if the price has not increased but if the stock goes to $50, he says I will now take those 1,000 shares at the price you promised, $35. There is my check for $35,000."

You might wonder where he got the $35,000. He went to a banker who said, "You bring that 1,000 shares of stock to me, and I will lend you $35,000 on it." The banker is holding the stock and the boss gets the $35,000.

Six months later, and you have to wait six months, the banker calls up this employee and says, "Look. I have your note here for $35,000. It is true it is secured by 1,000 shares of stock, but we can't hold it forever." So since the whole device was intended to let the employee make money, the employee authorizes the banker to sell those shares for $50,000. The bank keeps the $35,000 which it had loaned the employee. The employee gets to keep $15,000, of which Uncle Sam takes 26 per cent.

I promised to show you how you could save taxes by borrowing money. This is a special attraction only for corporations which have to pay an excess profits tax. If you do not pay excess profits tax, do not do this.

If you are paying an excess profits tax, do it, provided you can satisfy the government that you really needed that money in the business, and one good argument with the government is to say, "With all the high excess profits tax which we have to pay, we certainly need to borrow money to keep the working capital intact!"

Let us assume that your business is of a scope which justifies borrowing one million dollars, so we will assume a loan of a million dollars at interest of 4 per cent. That means you will pay in interest of $40,000 a year. Of course, if this loan is in effect only a half year, you will only have half the benefits. Try not to pay it back.

Now, the first thing that happens when you pay this interest of $40,000 a year is that you get a deduction on your corporation income tax, normal and surtax, which is now 52 per cent. You save. It reduces your tax by 52 per cent because that is an additional deduction. That cuts your taxes $20,700. That is item number one.

The next thing that happens is that 25 per cent of the $40,000 interest (not all of it, they do not allow you to deduct the entire amount, only one-fourth of it), or $10,000 off excess profits tax is deductible. The rate is 30 per cent. Thirty per cent of $10,000 is $3,000, saving number two.

On top of that, when you borrow a million dollars, you are permitted to include in your excess profits credit calculation as capital addition during the period, 75 per cent of that loan, or $750,000. Twelve per cent of the $750,000 is allowed as an addition to excess profits credit. You make 12 per cent on the borrowed capital. When you borrow a million dollars, $750,000 is considered borrowed capital. Twelve per cent of that $750,000 may be added to excess profits credit. That amounts to $90,000. You have raised your credit by $90,000. You save 30 per cent of the $90,000, or $27,000, in excess profits taxes.

Let us summarize. You have saved in normal and surtax $20,800. You have saved by having an interest deduction in the excess profits tax schedule $3,000. You have saved by increasing your excess profits credit $27,000. The total is $50,800.

Therefore, your incurring an obligation of a million dollars and paying interest of 4 per cent, or $40,000 has saved you a total of $50,800.

I imagine when Congress wakes up to the fact that that is what they have done in the excess profits tax law, you will probably find an amendment in the next revision, and one of the reasons we have so many revisions is because each law attempts to tighten the tax procedures after loopholes are discovered. Nobody has to sit up nights to find the loopholes.

Here is the very earliest big loophole which started the beginning of loopholes. Prior to 1921 the law said that if you buy a building and sell it, the tax is on the profit, and that is the difference between what you pay for it and what you sold it for. Suppose you received it as a gift, or you received it by inheritance. Then what do you start with? At that time the law said if you sell a piece of property for a certain sum of money, and you received it by gift, you start with a fair market value of the property on the day of gift.

If the property was worth $100,000 when you received it, and you sell it for $200,000, you have $100,000 gain. Can you see any loophole there? Doesn't that seem logical? If your father says, "Son I own a business building on High Street. I hereby give it to you. It is yours. You keep the income from it." Even if a year later you sell it, doesn't it sound logical that in figuring your profit, you take what it was worth the day you got it, and compare that with what you got for it?

Here was the loophole. Mr. A received such a building, a gift from his father. On the date of the gift it was worth $100,000. Ten years later Mr. A is offered $200,000 for that building. He is just about to sell when he bumps into a tax adviser, and he tells him about what is going on. He is going to sell the building.

"No," says the tax adviser, "don't sell that building. If you do, you will have a profit of $100,000 which you will have to pay tax on. You don't want to do that." So Mr. A gives the property to his wife. Then he persuades her to sell her building for $200,000. She does, and she has no tax at all because she received it by gift. As such, the basis in her band is the fair market value on the date of the gift. Obviously that is $200,000. She takes her $200,000 building and sells it for $200,000. She has no gain, no tax. The money is in the family. That was the first loophole that was plugged in 1921.

The law says that the basis, meaning the value in your hand of property received by gift after December 31, 1920 shall be the cost to the donor. Back to the original donor. And if Mr. A's father, who gave him the building, paid $50,000 for it years ago, and gave it to the son when it was worth $100,000, and it was sold later for $200,000, the gain was $150,000. It goes as far back as the original donor.

We have nothing more than a series of loophole pluggings because of such innocent situations, which at the time the law was written, nobody could foresee would be there, or that there would be any possible flaw.

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ROEDGER, FRED E., Western Reserve University, Cleveland
RONK, JACK H., I. B. M. Corporation, Columbus
ROOT, PEGGY, Touche, Niven, Bailey & Smart, Dayton
ROWLAND, P. V., Armco Steel Corporation, Zanesville
ROYER, WILLIAM F., Haskins and Sells, Detroit, Mich.
RUDD, WILLIAM A., William A. Rudd, Inc., Columbus

SANDMAIER, P. J., Haskins & Sells, Cleveland
SCHERER, BELDEN D., The Goodyear Tire and Rubber Company, Akron
SCHINDLER, JAMES S., Washington University, St. Louis, Mo.
SCHMIDT, CHARLES, Lybrand, Ross Bros. and Montgomery, Cincinnati
SCHNEIDER, ROY D., Marden Long, C.P.A., Columbus
SEAMAN, J. A., Thew Shovel Co., Lorain
SELBY, JAMES W., The Sparta Ceramic Company, East Sparta
SHAPER, HERBERT E., Dayton
SHERER, E. E., Farm Bureau Mutual Insurance Company, Columbus
SHILTS, ALLAN R., Lincoln-Mercury Division, Detroit, Mich.
SHOAF, HARRY G., Meaden and Moore, Cleveland
SHOCKCOR, J. C., The Lennox Furnace Company, Columbus
SHONK, RICHARD L., Warner & Swasey Company, New Philadelphia
SIMMERMACHER, LOUIS W., Wright Patterson A. F. Base, Dayton
SKEEL, THOMAS E., Cleveland Electric Illuminating Company, Cleveland
SMITH, HARRY T., Shellmar Products Corporation, Mt. Vernon
SMELTZER, RICHARD S., Port Huron Sulphite & Paper Co., Port Huron, Mich.
SMART, GUY A., Massillon
SOLOWAY, EUGENE S., Soloway and Von Rosen, Cleveland
SONKIN, HARRY, Alexander Grant and Company, Cincinnati
SPEES, L. S., Keller, Kirschner, Martin & Clinger, Columbus
STACEY, N. A. H.
STANS, MAURICE
STARR, A. J., Lybrand, Ross Bros. & Montgomery, Cincinnati
STEVENSON, ROBT. K., The Beckett Pa Company, Hamilton
STRENG, R. S., Keller, Kirschner, Martin & Clinger, Columbus
SWANK, F. W., Owens-Corning Fiberglas Corporation, Newark

SWARTZ, E. J., Union Metal Manufacturing Company, Canton
SWORMSTEDT, CHAS W., Haskins & Sells, Cincinnati

TALMAGE, GEORGE B., Lybrand, Ross Bros. and Montgomery, Cleveland
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THOMPSON, ROBERT N., U. S. Navy, Columbus
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TRACY, PAUL A., The Central Ohio Paper Company, Columbus
TROXELL, JAMES R., The Brush-Moore Newspapers, Inc., Canton
TUCKER, R. J., National Advisory Committee for Aeronautics, Cleveland

UHL, R. J., Hydraulic Press Manufacturing Company, Mt. Gilead

VILLHAUSER, MELVIN H., Arthur Young and Company, Toledo
VISCI, V. H., Thew Shovel Company, Lorain
VLAHOS, JOHN K., Trout & Barstow, Dayton
VOLPE, A. N., Lybrand, Ross Bros. and Montgomery, Cleveland
VON REICHBAUER, WILLIAM, Fenn College, Cleveland
VON ROSEN, URBAN F., Soloway and Von Rosen, Cleveland

WALD, ALBERT, Miami University, Oxford
WALKER, SCOTT H., Meaden & Moore, Cleveland
WALKER, W. B., Columbus & Southern Ohio Electric Co., Columbus
WARE, L. L., Touche, Niven, Bailey & Smart, Dayton
WEAMER, L. C., Armco Steel Corporation, Montcoal, W. Va.
WEIDLER, WALTER C., The Ohio State University, Columbus
WEEKS, WILLIAM, Keller, Kirschner, Martin & Clinger, Columbus
WERNER, RICHARD B., Ohio University, Athens
WEYRICH, HARRY R., Haskins and Sells, New York, N. Y.
WILSON, F. E., Armco Steel Corporation, Middletown
WOLTZ, HARRY J. P., Elyria
WOOD, DONALD G., Anchor Hocking Glass Corporation, Lancaster
WOOHERY, PARIS E., Industrial Commission of Ohio, Columbus
WOODRING, KENNETH R., Meaden & Moore, Cleveland

ZEIGLER, JOHN H., Medina
ZUNICH, MITCH, Lybrand, Ross Bros. and Montgomery, Cleveland

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* Management addresses.